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Department of the Treasury
Internal Revenue Service

Publication 525

Taxable and Nontaxable Income

For use in preparing
1989 Returns

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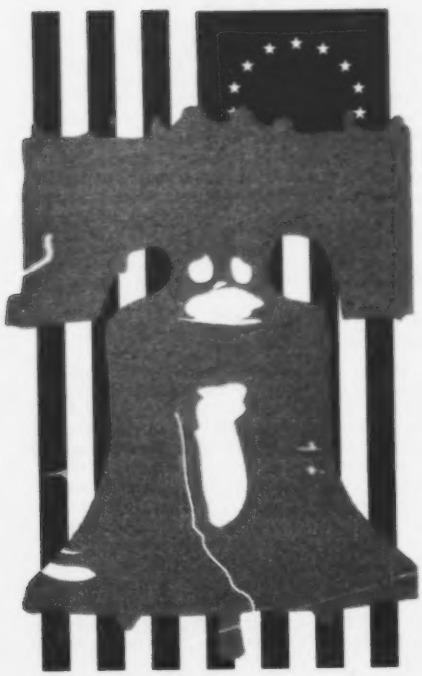

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Important Changes

Educational assistance provided by your employer. Beginning in 1989, you can no longer exclude from income the cost of educational assistance provided to you by your employer under a qualified plan.

Pending legislation. As this publication was being prepared for print, Congress was considering legislation that would extend the exclusion for amounts received as educational assistance from your employer under a qualified plan. For information on any late legislative changes, get Publication 553, *Highlights of 1989 Tax Changes*.

Jury duty pay. If you are required to give your jury duty pay to your employer because your employer continues to pay your salary while you serve on the jury, you can, beginning in 1987, deduct the amount repaid as an adjustment to gross income, rather than as an itemized deduction. See *Jury duty pay*, later.

Dependent care assistance. Amounts you exclude from income as dependent care assistance provided by your employer reduce the dollar limit on employment-related expenses you can use to figure your child care credit. See *Dependent care assistance*, later.

Pending legislation. As this publication was being prepared for print, Congress was considering legislation that would affect how to figure long-term capital gains. For information on this legislation, get Publication 550, *Investment Income and Expenses*, or Publication 553, *Highlights of 1989 Tax Changes*.

Important Reminders

Dependent care assistance. Generally, you can exclude from income dependent care assistance you receive from your employer. However, the amount you can exclude is limited to the smaller of your earned income, your spouse's earned income, or $5,000 ($2,500 if you are married filing a separate return). See *Dependent care assistance*, later.

Employee achievement awards. Employee achievement awards you receive are excludable from gross income only if they meet certain conditions. See *Employee achievement awards* under *Income Not Taxed*, later.

Unemployment compensation. All unemployment compensation you receive must be included in income. See *Unemployment compensation*, later.

Scholarships and fellowship grants. You must be a candidate for a degree to exclude from income amounts you receive as a qualified scholarship. See *Qualified scholarships*, later.

Qualified retirement plans. Under certain types of retirement plans, you can have part of your pay each year put into one or more retirement accounts. The amount put into the accounts is not included in income until you withdraw it. See *Employer's contributions to qualified plan*, later. Tax-sheltered annuities are subject to higher limits. Get Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations*.

Introduction

All income that is not specifically exempt is taxable. You must keep accurate records of all your income that is not subject to withholding.

This publication discusses many types of income. However, some types of income are discussed in greater detail in other publications. You may find that you need more information from the following publications:

- Publication 527, *Residential Rental Property*
- Publication 550, *Investment Income and Expenses*
- Publication 564, *Mutual Fund Distributions*
- Publication 575, *Pension and Annuity Income*
- Publication 915, *Social Security Benefits and Equivalent Railroad Retirement Benefits*

Free Publications and Forms

If you need information on a subject not covered in this publication, you can check our other free publications. To order publications and forms, call our toll-free telephone number 1–800–424–FORM (3676) or write the IRS Forms Distribution Center for your area as shown in the income tax package.

Employee Compensation

Generally, you must include in gross income everything you receive in payment for personal services. In addition to wages, salaries, commissions, fees, and tips, this includes other forms of compensation such as fringe benefits and stock options. Check the index for the location of a specific subject.

Miscellaneous Compensation

This section explains many types of employee compensation. The subjects are arranged in

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alphabetical order followed by *Restricted Property Received for Services*, which is explained in greater detail.

Advance commissions and other earnings. If you receive advance commissions or other amounts for services to be performed in the future, and you are a cash method taxpayer, you must include these amounts in income in the year received.

If you repay unearned commissions or other amounts in the same year in which you received them, you reduce the amount to include in income by the repayment. However, if you repay the unearned commissions or other amounts in a later tax year, you can deduct the repayment as an itemized deduction on your Schedule A (Form 1040), or you may be able to take a credit, for that year. See *Repayments* later.

Back pay awards. Amounts you are awarded in a settlement or judgment for back pay, including unpaid life insurance premiums and unpaid health insurance premiums, are included in your gross income. They should be reported to you by your employer on Form W–2, *Wage and Tax Statement*.

Bonuses and awards paid to you for outstanding work are income and should be shown on your Form W–2. These include prizes such as vacation trips for meeting sales goals. If a prize or award is in goods or services, you must include the fair market value of the goods or services in income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you. If you receive an award for length of service or safety achievement, see *Employee achievement awards* under *Income Not Taxed*, later.

Christmas gifts. If your employer gives you a turkey, ham, or other item of nominal value at Christmas or other holidays, the value of the gift is not income. However, if your employer gives you cash, a gift certificate, or similar item that you can easily exchange for cash, the value of the gift is extra salary or wages regardless of the amount involved.

Government cost-of-living allowances are generally not included in income of federal civilian employees, including federal court employees, stationed in Alaska, Hawaii, or elsewhere outside the 48 contiguous states or the District of Columbia.

Allowances and differentials that increase your basic pay as an incentive for taking a less desirable post of duty are part of your compensation and must be included in income. For example, your compensation includes Foreign Post, Foreign Service, and Overseas Tropical differentials. For more information, get Publication 516, *Tax Information for U.S. Government Civilian Employees Stationed Abroad*.

Cost-of-living allowances paid to Red Cross staff members stationed outside the 48 contiguous states are included in salary or wages.

Interview expenses. If an employer asks you to appear for an interview and pays you an allowance, or reimburses you for your transportation and other travel expenses, you include in income on line 22, Form 1040, only the amount you receive that is more than your actual expenses.

Moving expense allowances or reimbursements are included in your salary or wages for the tax year in which you receive them. For details, get Publication 521, *Moving Expenses*.

Pension and annuity contributions. Generally, you cannot exclude from income amounts you pay into a pension plan through payroll deductions.

Contributions to Federal Thrift Savings Fund. Federal employees can choose to make contributions from their salaries to the Federal Thrift Savings Fund. Contributions are not included in your income. Your salary of record before contributions are taken out is used for purposes of social security taxes and benefits. Payments from the fund are taxable as a distribution from a qualified pension or annuity plan.

Employer's contributions to qualified plan. Generally, your employer's contributions to a qualified pension plan for you are not included in income at the time contributed. However, employer contributions that are made out of funds that would otherwise have been paid to you as salary, except that you entered into a salary reduction agreement with your employer (elective deferrals), are excluded from income only up to a limit.

For 1989 you cannot set aside more than a total of $7,627 for all elective deferrals. If you set aside more than $7,627, the excess is included in gross income that year. Contributions to tax-sheltered annuities are subject to a higher limit. Get Publication 571.

The cost of life insurance coverage included in an employer's plan may be income if the proceeds of the policy are payable directly or indirectly to your beneficiary. See *Group Life Insurance Premiums*, later, under *Fringe Benefits*.

Amounts actually distributed or made available to you generally are taxable, unless they are eligible for tax-free rollover and are rolled over (normally, within 60 days after receipt) to another qualified plan or to an individual retirement account or annuity. Your employer may be able to tell you how the amount you receive is taxed, or get Publication 575, for more information.

Employer's contributions to nonqualified plan. If your employer pays into a nonqualified plan for you, you generally must include the contributions in income as wages for the tax year in which the contributions are made. However, if your interest is not transferable and is subject to a substantial risk of forfeiture at the time of the payment, you need not include the value of your interest in income. When your interest becomes transferable or is no longer subject to a substantial risk of forfeiture, you must include the value in income.

Railroad retirement annuities. If you received tier 1 railroad retirement benefits greater than the "social security equivalent benefit," or tier 2 or vested dual benefits, these payments are treated as pension or annuity income, and are taxable under the rules explained in Publication 575.

Property purchased from employer. If your employer allows you to buy property at a price below its fair market value as compensation for your services, you must include in income as extra wages the difference between the property's fair market value and the amount you paid for it.

Independent contractors. If your services are paid for by allowing you to buy property at reduced rates, you must include in income on Schedule C (Form 1040) the fair market value of the property at the time it is turned over to you, reduced by the amount you paid for it.

Severance pay is taxable. A lump-sum payment for cancellation of your employment contract is income in the tax year you receive it and must be reported with your other salaries and wages.

Accrued leave payment. If you are a federal employee and receive a lump-sum payment for accrued annual leave when you retire or resign, this amount will be shown on your Form W–2.

If you resign from one agency and are reemployed by another agency, you may have to repay part of your lump-sum annual leave payment to the second agency. You can reduce gross wages by the amount you repaid in the same tax year in which you received it. You should attach to your tax return a copy of the receipt or statement given to you by the agency to which you make repayment to explain the difference between the wages on your return and the wages on your Forms W–2.

Sick pay. Amounts you receive from your employer while you are sick or injured are part of your salary or wages. You must include in income payments made by:

1) Your employer.
2) A welfare fund.
3) A state sickness or disability fund.
4) An association of employers or employees.
5) An insurance company, if your employer paid for the plan.

However, if you paid the premiums on an accident or health insurance policy, the benefits you receive under the policy are not taxable. For more information, see *Other Sickness and Injury Benefits* under *Disability Income*, later.

Social security tax paid by employer. If you and your employer have an agreement that your employer pays your social security tax without deducting it from your gross wages, your employer must include the amount of tax paid as wages reported on Form W–2. The payment is treated as wages for figuring social security tax and social security benefits. However, the treatment of the payment as social security wages does not apply to domestic workers in private homes or agricultural workers.

Stock appreciation rights. If your employer grants you a stock appreciation right, do not include it in income until you exercise the right. When you exercise the right, you are entitled to a cash payment equal to the amount the fair market value of the corporation's stock on the date of exercise has increased over the fair market value on the date the right was granted. You include the cash payment in income in the year you exercise the right.

Violation of civil rights. Payments to employees resulting from a suit for violation of Title VII of the Civil Rights Act of 1964 are included as compensation in the employees' gross income as wages. They are also "wages" for employment tax purposes.

Withholding. Amounts withheld from your pay for income tax, social security tax, or savings bonds are considered received by you. They will be included on your Form W–2 in the year they were withheld. The same generally is true of amounts withheld for taxable fringe benefits, pensions, insurance, union dues, and other assessments, as discussed later in this publication. For more information on withholding, get Publication 505, *Tax Withholding and Estimated Tax*.

If your employer uses your wages to pay your debts, or if your wages are attached or garnished, the full amount is considered received by you. Also included in your wages are fines or penalties withheld from your pay.

Work-training programs. If you are enrolled in a state or local work-training program under the Economic Opportunity Act of 1964, payments you receive as compensation for services are wages.

Restricted Property Received for Services

Generally, the fair market value of property you receive for your services must be included in income in the year you receive the property. However, if you receive stock or other property that has certain restrictions that affect its value, you do not include the value of the property in income until it has been ***substantially vested*** (discussed later). You can choose to include the value of the property in income in the year it is transferred to you, as discussed later, rather than the year it is substantially vested. Until the property becomes substantially vested, it is owned by the person who makes the transfer to you, usually your employer. However, any income from the property, or the right to use the property, is included in

income as wages in the year you receive the income or have the right to use the property.

You must include as compensation, in the year the restricted property becomes substantially vested, the fair market value of the property at that time, minus any amount you paid for the property.

Example. On July 1 the RST Corporation, your employer, sells you 100 shares of its stock at $10 a share. At the time of the sale the fair market value of the stock is $100 a share. Under the terms of the sale, the stock is under a substantial risk of forfeiture (that is, you could lose it) for a 5-year period. Because your stock is not substantially vested when it is transferred, you do not include any amount in income in that year. At the end of the 5-year period the fair market value of the stock is $200 a share. You must include $19,000 in income (100 shares of stock times $200 fair market value for each share minus $10 paid for each share). Dividends paid by the RST Corporation on your 100 shares of stock are taxable to you as compensation after the date of transfer.

Substantially vested. Property is substantially vested when:

1) It is transferable, or
2) It is not subject to a substantial risk of forfeiture (you do not have a good chance of losing it).

Transferable property. Property is transferable if you can sell, assign, or pledge your interest in the property to any person (other than the transferor), and if the person receiving your interest in the property is not required to give up the property, or its value, if the substantial risk of forfeiture occurs.

Substantial risk of forfeiture. A substantial risk of forfeiture exists if the rights in the property transferred depend on the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a certain condition related to the transfer.

Example. The Spin Corporation transfers to you as compensation for services 100 shares of its corporate stock for $100 a share. Under the terms of the transfer, you must resell the stock to the corporation at $100 a share if you leave your job for any reason within 3 years from the date of transfer. Because you must perform substantial services over a period of time and you must resell the stock to the corporation at $100 a share regardless of its value if you do not perform the services, your rights to the stock are subject to a substantial risk of forfeiture.

Choice to include in income in year of transfer. You can choose to include the value of the property at the time of transfer (minus any amount you paid for the property) in income in the year it is transferred, rather than in the year it is substantially vested. If you make this choice, the substantial vesting rules do not apply and, generally, any later appreciation in value is not included in your compensation when the property becomes substantially vested.

To figure gain or loss when you sell the property, your basis is the amount you paid for it, plus the amount you included in income as compensation. If you forfeit the property after you have included its value in income, your loss is the amount you paid for the property minus any amount you realized on the forfeiture.

You cannot revoke the choice without the consent of the IRS. Consent will only be given if you made a mistake of fact as to the underlying transaction.

You make the choice by filing a written statement with the Internal Revenue Service Center where you file your return. You must file this statement no later than 30 days after the date the property was transferred. A copy of the statement must be attached to your tax return for the year the property was transferred. You also must give a copy of this statement to your employer and, if someone other than you received the property, to that person.

You must sign the statement and indicate on it that you are making the choice under section 83(b) of the Internal Revenue Code. The statement must contain all of the following information:

1) Your name, address, and taxpayer identification number.
2) A description of each property for which you are making the choice.
3) The date or dates on which the property was transferred and the tax year for which you are making the choice.
4) The nature of any restrictions on the property.
5) The fair market value at the time of transfer (ignoring restrictions except those that will never lapse) of each property for which you are making the choice.
6) Any amount that you paid for the property.
7) A statement that you have provided copies to the appropriate persons.

Dividends received on restricted stock. Dividends you receive on restricted stock are extra compensation to you. Restricted stock is stock you received from your employer and did not include in income because it was not substantially vested. Your employer should include these payments on your Form W–2. If they are also reported on a Form 1099–DIV, you should list them on Schedule B (Form 1040), with a statement that you have included them as wages. Do not include them in the total dividends received.

Dividends you receive on stock you chose to include in income in the year transferred are treated the same as any other dividends. If you receive both a Form 1099–DIV and a Form W–2 showing these dividends, do not include the dividends in your wages reported on line 7, Form 1040. List the dividends on line 4, Part II of Schedule B, along with your other dividends. Attach a statement to your Form 1040 explaining why the amount shown on line 7 of your Form 1040 is different from the amount shown on your Form W–2.

Sale of property not substantially vested. These rules apply to the sale or other disposition of property that is not substantially vested and not included in income in the year transferred.

If you sell or otherwise dispose of the property in an arm's-length transaction, you include in income the amount realized minus the amount you paid for the property. This should be included according to your method of accounting. If you exchange the property in an arm's-length transaction for other property that is not substantially vested, treat the new property as if it were substituted for the exchanged property.

If you sell the property in a transaction that is not at arm's length, report as compensation on your tax return for the year of sale the total of any money received and the fair market value of any substantially vested property received on the sale. In addition, you will have to report income when the original property becomes substantially vested. You figure this additional income as if you still held the original property. You include the fair market value in income, minus the total of the amount you paid for the property and the amount included in income from the earlier sale.

Example. In 1987, you pay your employer $50 for a share of stock that has a fair market value of $100 and is subject to forfeiture until 1989. In 1988, you sell the stock to your spouse for $10 in a transaction not at arm's length. You have income of $10 in 1988. In 1989, when the stock has a fair market value of $120, it becomes substantially vested. You have additional income reportable as wages in 1989 of $60, figured as follows:

Fair market value of stock at time of substantial vesting	$120
Minus: Amount paid for stock	50
	$ 70
Minus: Compensation included in income from sale to spouse	10
Additional income	$ 60

If you inherit property not substantially vested at the time of the decedent's death, any income you receive is considered income in respect of a decedent and is taxed according to the rules for restricted property received for services. For information about income in respect of a decedent, get Publication 559, *Tax Information for Survivors, Executors, and Administrators.*

Fringe Benefits

The value of fringe benefits you receive from your employer is taxable and must be included in your income as compensation, unless the benefits are specifically excluded by law or you pay fair market value for them. The value of the benefits is determined by valuation rules explained later in *Taxation of Certain Fringe Benefits.*

Certain fringe benefits are specifically excluded by law. These include:

1) No-additional-cost service.
2) Qualified employee discount.
3) Working condition fringe.
4) De minimis (minimal) fringe benefit.

Each will be discussed separately. There are also discussions of the special rules for demonstration cars used by automobile salespersons, parking provided by employers, eating facilities on business premises, and gyms or other athletic facilities on business premises.

Preceding the discussions are definitions of "employee" and "line of business" as they relate to these benefits.

Employee

Generally, a person who currently performs services for an employer is considered the employee. However, the term "employee" may include other individuals.

No-additional-cost service and qualified employee discount. For purposes of these two benefits, the term "employee" includes:

1) Any individual who is currently employed by the employer in the line of business (see *Line of Business,* later).
2) A retired or disabled employee who was formerly employed in the line of business.
3) A surviving spouse of a current or former employee.
4) A spouse or dependent child of an employee (including a child whose parents have died and who has not reached age 25).
5) Any partner who performs services for the partnership.

For purposes of item (4) above, a child of divorced parents is treated as a dependent of both parents, if the child can be claimed as a dependent by either parent. In addition, any use of air transportation by the parent of an employee of an airline or airline affiliate will be treated as use by the employee. This does not include the parent of a surviving spouse of a deceased, retired, or disabled employee.

Working condition fringe benefit. For purposes of this benefit, the term "employee" includes:

1) Any individual who is currently employed by the employer.
2) Any partner who performs services for the partnership.
3) Any director of the employer.
4) Any independent contractor who performs services for the employer.

De minimis (minimal) fringe benefit. For purposes of this fringe benefit, the term "employee" means any recipient of a fringe benefit.

Line of Business

To be excluded from income, no-additional-cost services or qualified employee discounts must be for property or services offered for sale to customers in the same line of business in which you perform substantial services. This line of business limitation is not met if most of your employer's products or services are sold to employees rather than customers.

If you perform services in more than one of your employer's lines of business, you can only exclude no-additional-cost services and qualified employee discounts in lines of business in which you perform substantial services. However, if you perform substantial services that directly benefit more than one line of business of your employer, you are treated as performing substantial services in all such lines of business.

Example 1. ABC, Inc., operates three lines of business—a chain of hotels, general retail merchandise stores, and a chain of grocery stores.

Bob James manages one of the retail merchandise stores. Since retail merchandising is the only line of business of ABC, Inc., where Bob performs substantial services, he can exclude only qualified employee discounts from the retail merchandise line of business.

Example 2. Assume the same facts as Example 1. Rita Leonard retired as an accountant from ABC, Inc. While employed, she maintained accounts for all three lines of business of ABC, Inc. Therefore, she performed substantial services for all three lines of business. Rita can exclude from income qualified employee discounts from both the retail merchandise and grocery lines of business, and no-additional-cost services from the hotel chain line of business.

Interrelated minor line of business. If your employer has a minor line of business significantly interrelated with a major line of business, only employees of the minor line who perform services that directly benefit both the major and the minor lines of business are considered employees of both.

"Significantly interrelated" means the activity of the minor line of business is directly related to, but is a minor part of, the major line of business (such as laundry services provided at a hospital).

Example 1. Scott Mitchell is employed by the repair division of a retail merchandise store and repairs appliances sold by the store. Because the repair service is directly related to, but a minor part of the line of business of the sale of merchandise, Scott is considered to be an employee of the retail merchandise line of business.

Example 2. Ashlawn operates a hospital and a chain of laundry and dry cleaning stores. The substantial services performed by employees of the laundry service directly benefit the hospital. Only employees of the laundry service who perform substantial services which directly benefit the hospital will be treated as employees of the hospital line of business.

Affiliates of airlines. If you are employed by a qualified airline affiliate and are directly engaged in providing airline-related services, you do not include in income the value of air transportation provided by the airline.

A qualified airline affiliate is any corporation predominantly engaged in providing airline-related services: catering, baggage handling, ticketing and reservations, flight planning and weather analysis, or restaurants and gift shops located in an airport.

Multiple lines of business. If your employer has more than one line of business, all lines of business will be treated as a single line of business if one or more of the following apply:

1) It is uncommon in your employer's industry for any of the separate lines of business to be operated without the others.
2) It is common for a substantial number of employees (other than employees who work at the employer's main office or headquarters) to perform substantial services for more than one line of business, making it difficult to determine which employees perform substantial services for which line of business.
3) Retail operations located on the same premises but in separate lines of business are considered one line of business if the merchandise of both businesses would be sold in a department store.

Example 1. Your employer operates a delicatessen with an attached service counter at which food is sold for consumption on the premises. Most of the employees work both at the delicatessen and at the service counter. The delicatessen and the service counter are treated as one line of business.

Example 2. Your employer operates two separate lines of business on the same premises. One line is women's apparel and the other is jewelry. If these separate items were sold together in a department store, they would be part of one line of business and, therefore, are treated as one line of business.

No-Additional-Cost Service

You will not have to include in income the value of a no-additional-cost service if:

1) The service is offered for sale to customers in your employer's line of business in which you perform substantial services, and
2) Your employer does not incur any substantial additional cost, including foregone revenue, in providing this service to you.

Examples of no-additional-cost services are excess capacity services such as:

1) Hotel accommodations.
2) Telephone services.
3) Transportation by aircraft, train, bus, subway, and cruise line.

Non-excess capacity services are not eligible for exclusion as no-additional-cost services. For example, an employee's use of a stock brokerage firm to buy stock, or a mutual fund to buy an interest in the mutual fund, does not qualify. However, non-excess capacity services can be considered a qualified employee discount, discussed later.

No substantial additional cost. The exclusion for a no-additional-cost service applies only if your employer does not incur substantial additional cost in providing the service to you. The term "cost" includes revenue that is foregone (given up) because the service is provided to an employee rather than a nonemployee.

Whether your employer incurs substantial additional cost must be determined without regard to any amount you pay for the service. Thus, any reimbursement by you does not affect the determination of whether your employer incurs substantial additional cost.

Your employer generally incurs no substantial additional cost if services provided to you are merely incidental to the primary service being provided by your employer.

Example. Airline employees traveling on a space-available basis are provided in-flight meals and services by flight attendants. The meals and services are not considered substantial in relation to the air transportation provided.

Cash rebates. The exclusion for a no-additional-cost service applies whether the service is provided at no charge or at a reduced price. The exclusion also applies if the benefit is provided through a partial or total cash rebate of the amount you paid for the service.

Reciprocal agreements. You can exclude a no-additional-cost service provided by a different employer who has a written reciprocal agreement with your employer if the following conditions are met:

1) The agreement states that employees of each employer who perform substantial services in the same line of business can receive no-additional-cost services from the other employer.
2) The service provided to the employees is the same type provided to customers in the same line of business in which the employees perform substantial services.
3) Neither employer incurs substantial additional cost in providing the service to the other's employees. If one employer pays a substantial amount to the other employer in connection with the agreement, that employer has incurred a substantial additional cost.

Note. The value of the service can be excluded from the income of highly compensated employees only if the service is made available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer that does not discriminate in favor of highly compensated employees.

A "highly compensated employee" is an employee who in 1989 is:

1) A 5% owner at any time during the year (or preceding year),
2) Paid more than $81,720,
3) Paid more than $54,480 and in the top 20% of paid employees for the year, or
4) An officer and is paid more than $49,032.

Qualified Employee Discount

If your employer allows you to buy at a discount qualified property or services for your personal use, you will not have to include in income the value of the discount if:

1) The discount you get on property is not greater than the gross profit percentage of the price at which the property is offered for sale to customers, or
2) The discount you get on services is not greater than 20% of the price at which the services are offered to customers.

This exclusion applies whether the property or service is provided at no charge (in which case only part of the discount is excluded) or at a reduced price. The exclusion also applies if the benefit is provided through a partial or total cash rebate of an amount paid for the property or service.

Qualified property or services. The term "qualified property or services" means any property or services which are offered for sale to customers in the ordinary course of the line of business of your employer in which you perform substantial services.

Nonqualified property or services. The term "qualified property or services" does ***not*** include:

1) Real property.
2) Personal property, whether tangible or intangible, of a kind commonly held for investment.
3) Property or services of a kind that are not offered for sale to customers in the ordinary course of the employer's line of business.

Thus, you cannot exclude from income the amount of an employee discount on purchases of residential or commercial real estate, securities, commodities, currencies, or property or services that are offered for sale only to employees and their families.

No reciprocal agreements. The exclusion for a qualified employee discount does not apply to property or services provided by another employer under a written reciprocal agreement that exists between employers to provide discounts on property and services to employees of the other employer.

Discount provided by third party. A qualified employee discount may be provided by either your employer or a third party. However, if you receive additional rights that are not provided by your employer to customers in your employer's line of business in which you perform substantial services, the qualified discount applies only to the property and not the additional rights.

Example. Jay Barry works for an appliance manufacturer. He purchased at a retail store an appliance manufactured by his employer and received an employee discount. He also received a special one-year warranty on the appliance from the retail store. Jay's employer does not give these warranties to its customers. Jay can exclude from income the qualified employee discount on the purchase of the appliance, but not the value of the warranty.

Note. The value of the discount can be excluded from the income of highly compensated employees only if the discount is made available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer that does not discriminate in favor of highly compensated employees (defined under *No-Additional-Cost Service*, earlier).

Employee discount. The employee discount is:

1) The price at which the property or service is being offered by your employer for sale to customers, less
2) The price at which the property or service is provided to you by your employer for your personal use.

If you transfer the property without consideration (as a gift to a relative, for example), the property is considered provided for your use. The discount is eligible for exclusion as a qualified employee discount.

Price to customers. In determining the employee discount, the price at which the property or service is being offered to customers at the time of your purchase is the controlling factor. This price is not reduced by a quantity discount unless you actually purchase the required quantity of the product or service.

Damaged, distressed, or returned goods. If you pay at least fair market value for damaged, distressed, or returned property, you will not have income from this type of purchase.

Gross profit percentage. In general, the exclusion for an employee discount is limited to the price at which the property is being offered to customers in your employer's line of business, multiplied by your employer's gross profit percentage.

The gross profit percentage is the portion of total sales that represents your employer's profit. For more information on gross profit percentage, see *Fringe Benefits* in Publication 535, *Business Expenses*.

Excess discount. If your employee discount on the purchase of property is greater than the gross profit percentage, the excess discount is included in income. If your employee discount on a service is greater than 20%, the excess discount is included in income.

Leased section of a department store is a section of a department store where property is sold over-the-counter under a lease or license arrangement with another company. A cosmetic firm leasing floor space from a department store is an example of a "leased section." For purposes of determining which employees may receive qualified employee discounts, the leased section is treated as part of the line of business of the employer operating the department store. The employees of the leased section are treated as both employees of the department store and of the leased section if they perform substantial services at the leased section. In general, qualified employee discounts do not have to be offered to both department store and leased section employees for one group of employees to receive a discount from the other employer.

Working Condition Fringe

You do not include in income the value of a working condition fringe benefit. A working condition fringe is any property or service provided to you that, if you paid for the property or service, would be deductible as an employee business expense. Only expenses directly related to your business as an employee of your employer qualify as a working condition fringe.

Example. You are an employee of X Corporation. You are also a director of Y Corporation. You incurred travel expenses on a business trip for X Corporation. You accounted to X for your travel expenses and X fully reimbursed you for these expenses. X also provided air transportation for you to attend a board of directors' meeting of Y Corporation.

You can exclude from income the reimbursement for the business trip for X since you would be able to deduct this amount as an employee business expense. However, you must include in income the value of the air transportation to attend the directors' meeting, because this expense was not incurred in your business as an employee of X Corporation. If the employee business expense requirements are satisfied, you may be able to deduct the value of the air transportation. For more information, get Publication 463, *Travel, Entertainment, and Gift Expenses*.

Cars and other motorized highway vehicles. In general, the amount you can exclude as a working condition fringe is the amount that would be allowed as an employee business expense deduction if you paid for the availability of the vehicle.

Example. Your employer provides a vehicle for your use for a full year and the value for the year is $2,000. If you drive 6,000 miles that year for your employer's business and 2,000 miles for personal use, the value of the working condition fringe is figured as follows: 6,000 (business miles) divided by 8,000 (total miles) times $2,000 (total value) equals $1,500. The $1,500 value of the working condition fringe is not included in income. The remaining $500 value is for the personal use of the vehicle and must be included in your income.

When determining the value of your working condition fringe, you must consider the miles the vehicle is driven by other employees during the time the vehicle is available to you.

If you use an employer-provided car for both business and personal use, your employer has the option to include 100% of the value in income. See *Employer-provided car* under *How to Report Fringe Benefits*, later.

Note. For information concerning the requirements that must be met to substantiate the amount of your working condition fringe, get Publication 917, *Business Use of a Car*.

Qualified nonpersonal-use vehicles. The total value (100%) of the use of a qualified nonpersonal-use vehicle is excluded from income as a working condition fringe. The term "qualified nonpersonal-use vehicle" means any vehicle which is not likely to be used more than a minimal amount for personal purposes because of its nature or design.

Examples of qualified nonpersonal-use vehicles include clearly marked police and fire vehicles, ambulances used as such or hearses used as such, construction vehicles, and certain buses. Your employer can tell you if the vehicle you use qualifies as a nonpersonal-use vehicle.

Flights on employer-provided aircraft. In general, the amount you can exclude as a working condition fringe is the amount you would be allowed as an employee business expense deduction if you had paid for the flight. However, if your spouse and children accompany you primarily for personal reasons, the value of their flights is included in your income.

Product testing. If you do product testing and evaluation outside your employer's workplace, you can exclude the value of the use of the consumer goods if certain requirements are met. You must keep the product no longer than necessary to test and evaluate its performance and then return it to your employer. In addition, you must submit detailed reports on the testing to your employer. Your employer must meet certain requirements, also.

A director of the employer or an independent contractor who performs services for the employer cannot exclude the value of the use of consumer goods provided under a product-testing program.

Demonstration car. If you are a ***full-time car salesperson*** and you are provided a demonstration car to use in the sales area of your car dealer's sales office, you can exclude from income the value of the car if:

1) The car is provided mainly so you can help your employer.
2) There are ***substantial restrictions*** on your personal use of the car.
3) The car is currently in the inventory of the automobile dealership.
4) The car is available for test drives by customers during your normal business hours.

Full-time car salesperson. You are a full-time car salesperson if you are employed by an automobile dealer and you meet all the following requirements. You must:

1) Customarily spend at least half of your normal business day on the sales floor selling cars to customers of the dealership.
2) Customarily work full time as a car salesperson (not less than 1,000 hours per year) for the dealership.
3) Earn at least 25% of your gross income from the dealership directly as a result of your car sales activities.

An individual, such as a general manager of a dealership, who receives a sales commission on the sale of cars is not a full-time salesperson unless these requirements are met. Use of a demonstration car by anyone other than a full-time car salesperson cannot be excluded from income.

Substantial restrictions on your personal use of a demonstration car exist when all of the following conditions are met:

1) Use by anyone other than you and other full-time salespersons, such as members of your family, is prohibited.
2) Use for personal vacation trips is prohibited.
3) The storage of personal possessions in the car is prohibited.
4) The use outside of your normal working hours is limited to a certain number of miles.

The sales area includes the geographic area around the dealer's office from which the office regularly draws customers. With respect to a particular salesperson, the sales area is the larger of the area within a 75-mile radius or the one-way commuting distance for that salesperson.

Parking. You do not have to include in income the value of free parking facilities provided to you on or near your employer's business premises. This also applies if you are reimbursed by your employer for renting a parking space on or near the business premises. It does not apply to any parking facilities located on property you own or lease for residential purposes. An independent contractor who performs services for the employer cannot exclude from income the value of parking.

If your employer gives you a general transportation allowance that you do not have to use for parking, you cannot exclude any part of the allowance, even if you do use it for parking.

De Minimis (Minimal) Fringe Benefits

You do not have to include in income a fringe benefit so small in value that it would be unreasonable or administratively impractical for your employer to account for it. Examples of minimal fringe benefits are occasional typing of personal letters by a company secretary, occasional personal use of your employer's copying machine, occasional parties for employees, occasional tickets to the theater or sporting events, discount transit passes not over $15 a month, and occasional supper money or taxi fares if you work overtime.

In determining the value of the benefit, your employer must consider how often similar fringe benefits are provided to each individual employee. If it is unreasonable or impractical to determine this on an individual basis, your employer may consider how often the benefits are provided to all employees.

Example 1. Your employer provides a free meal to you every day, but does not provide meals to other employees. The value of the meals is not minimal to you, even though it is if all employees are considered.

Example 2. You often use your employer's copying machine for personal items. However, the machine is used at least 85% of the time for business purposes since your employer restricts personal use of the copying machine. Even though you use the machine for personal purposes more than other employees, your use is considered minimal.

If the value of a benefit is not minimal, the entire value of the benefit must be included in income. For example, if your employer provides a $20 monthly transit pass to you, the entire $20 must be included in income, not just the amount over the $15 limit.

Certain eating facilities. If your employer provides meals to you in an employer-operated eating facility at a reduced cost, you do not have to include in income the difference between the cost of the meals and their fair market value if all of the following conditions are met:

1) The yearly income from the facility equals or is more than the cost of operating the facility.
2) The facility is available to all employees and not primarily for the benefit of highly compensated employees.
3) Your employer owns or leases the facility and it is located on the business premises.
4) The meals are provided on your work days.

Your employer is considered the operator of the facility whether it is operated by employees or an independent contractor.

If the exclusion for meals at an employer-provided eating facility is not available, you must include in income the difference between the value of the meals and the amount you pay for them. However, you may be able to exclude the value of meals your employer provides to you for his convenience if certain conditions are met. See *Meals and Lodging*, later.

On-Premises Athletic Facilities

If your employer operates an athletic facility (gym, pool, tennis courts, golf course, etc.) on premises owned or leased by your employer, you do not have to include in income the value of this fringe.

Your employer is considered the operator of the facility whether it is operated by employees or an independent contractor. To qualify, substantially all of the use of this facility must be by employees, their spouses, and dependent children (as defined earlier under *Employee*). Therefore, a membership in a health club or country club not meeting these requirements would not qualify for the exclusion. This exclusion does not apply to any athletic facility that is a facility for residential use.

Group Life Insurance Premiums

Group-permanent life insurance premiums paid by your employer for you are ordinary income to you and must be reported as part of your wages.

Bought for employees. In general, payments for up to $50,000 of group-term life insurance coverage provided to you by your employer are not included in income. Employer payments for insurance that exceeds the first $50,000 of coverage must be included in income.

Form W–2. The amount included in income is reported as part of wages on your Form W–2 and is shown separately on the form. If you paid any part of the cost of the insurance and the payment qualifies to reduce the amount included in income, the reduced amount would be shown on Form W–2. See *If you pay any part*, later.

Retired employees. If you are a retired employee, you will also have to include in income payments for insurance coverage in excess of $50,000, unless you qualify to exclude the payments.

Full exclusion. You can exclude from income the entire cost of the insurance if you had reached ***retirement age*** and you:

1) Retired by January 1, 1984, and
2) Were covered by the group-term life insurance plan when you retired.

You can also exclude the insurance cost if you had reached ***retirement age*** and you:

1) Retired after January 1, 1984, and before January 1, 1987, provided:
   a) You were age 55 on or before January 1, 1984, and
   b) The plan was maintained by the same employer for whom you worked during 1983, or by a successor employer, or
2) Retire after December 31, 1986, provided:
   a) Items 1(a) and (b) apply, and
   b) The plan, after 1986, meets the nondiscrimination rules.

Retirement age. The exclusion does not apply if you retired before reaching retirement age. You must include in income employer payments for insurance that exceeds the first $50,000 of coverage until you reach retirement age. ***Retirement age*** is the earlier of:

1) The age at which you first have the right to retire without disability or your employer's consent, and receive full retirement benefits, or
2) The age at which your employer requires employees to retire due to age.

Group-term life insurance is term life insurance protection (insurance for a fixed period or time) that:

1) Provides a general death benefit that can be excluded from income.
2) Is provided to a group of employees.
3) Is provided under a policy carried by the employer.
4) Provides an amount of insurance to each employee based on a formula that prevents individual selection.

If you pay any part of the cost of the insurance, your entire payment reduces, dollar for dollar, the amount your employer would otherwise include in income. See *Form W–2*, earlier. However, you cannot reduce the amount to include in income by:

1) Payments for future year coverage.
2) Prepayments for coverage after retirement.
3) Payments not taxed to you because of the exceptions discussed below.

Permanent benefits. If your group-term life insurance policy includes permanent benefits, such as a paid-up or cash surrender value, you must include in income, as wages, the cost of the permanent benefits, reduced by the amount you pay for them. Your employer should be able to tell you the amount to include in income.

Accidental or other death benefits in policies that do not provide general death benefits (travel insurance, for example) are not included as group-term life insurance coverage.

Exceptions. You are not taxed on the cost of this insurance if any of the following apply:

1) The coverage is provided after you have retired for disability.
2) Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year.
3) The only beneficiary is a charitable organization to which contributions are deductible for the entire period the insurance is in force during the tax year. You are not entitled to a deduction for a charitable contribution by naming a charitable organization as the beneficiary of your policy.

You are taxed on the entire cost of group-term life insurance protection provided by your employer through a qualified employees' trust, such as a pension trust or a qualified annuity plan.

Full-time life insurance agents who are considered employees for social security tax purposes are treated as employees in applying the provisions relating to group-term life insurance under a policy carried by their employer.

If you have only one employer and you were insured at any time during the tax year for more than $50,000 under a group-term life insurance policy, your income from this source is shown as other compensation on the Form W–2 you receive.

If two or more employers provide you group-term life insurance coverage totalling more than $50,000, you must figure how much to include in income for the cost of all coverage that is more than $50,000. You must include the cost of life insurance provided to you during the tax year, regardless of when your employers paid the premiums.

You figure the cost for each month of coverage by multiplying the number of thousands of dollars of insurance coverage, less $50,000 of insurance, both figured to the nearest tenth, by the cost from the following table. You must prorate the cost from the table if less than a full month of coverage is involved.

COST PER $1,000 OF PROTECTION FOR ONE MONTH

Age	Cost
Under 30	8 cents
30 through 34	9 cents
35 through 39	11 cents
40 through 44	17 cents
45 through 49	29 cents
50 through 54	48 cents
55 through 59	75 cents
60 and older	$1.17

Example. You are 51 years old and work for employers A and B. Both employers provide group-term life insurance coverage for you. Your coverage with employer A is $35,000 and with employer B is $45,000. You pay premiums of $50 a year under the employer B group plan. You figure the amount to include in income as follows:

Employer A coverage (in thousands)	$ 35
Employer B coverage (in thousands)	45
Total coverage (in thousands)	$ 80
Minus: Exclusion (in thousands)	50
Excess amount (in thousands)	$ 30
Multiply by cost per $1,000 per month, age 51 (from table)	.48
Cost of excess insurance for 1 month	$ 14.40
Multiply by number of full months coverage at this cost	12
Cost of excess insurance for tax year	$172.80
Minus: Premiums you paid	50.00
Cost to include in income as wages	$122.80

"Split dollar" life insurance plans. You may have a life insurance policy for which your employer pays part of each premium equal to the increase in the cash surrender value of the policy, and you pay only the rest of the premium, if any. If you die, your employer is to be paid an amount out of the proceeds about equal to the cash surrender value of the policy, with the rest of the proceeds to be paid to your beneficiary. You must include in your gross income each year, as wages, an amount equal to the one-year term cost of the declining life insurance protection you receive, minus any part of the premium that you pay.

For information on employer payments for group-term life insurance, get Publication 535.

Meals and Lodging

You do not include in income the value of meals and lodging provided to you and your family by your employer at no charge if the following conditions are met:

1) Meals are:
   a) Furnished on the business premises of your employer, and
   b) Furnished for the convenience of your employer.
2) Lodging is:
   a) Furnished on the business premises of your employer,
   b) Furnished for the convenience of your employer, and
   c) A condition of your employment (you are required to accept it).

Your family, for this purpose, includes only your spouse and your dependents.

Lodging includes the cost of heat, electricity, gas, water, sewer service, and similar items needed to make the lodging habitable.

Your employer's place of business generally means your workplace. For example, if you work as a housekeeper, meals and lodging provided in your employer's home are provided at your employer's place of business. Similarly, meals provided to cowhands while herding cattle on land leased or owned by their employer are considered provided at their employer's place of business.

Your employer's convenience. Whether meals or lodging are provided for your employer's convenience must be determined from all the facts. Meals or lodging provided to you and your family by your employer will be considered provided for your employer's convenience if there is a good business reason for providing the meals or lodging, other than merely giving you more pay.

If your employer has a good business reason for providing the meals or lodging, you do not include their value in income, even though your employer may also intend them as part of your pay. Thus, you can exclude the value of meals or lodging from income even if a law or your employment contract says that they are provided as compensation.

On the other hand, if meals or lodging are provided to you or your family by your employer as a means of giving you more pay, and there is no other business reason for providing them, their value is extra income to you.

Condition of employment means you must accept the lodging to properly carry out the duties of your job. For example, you must be available for duty at all times.

Social security tax. If the value of meals and lodging is not income to you under these rules, it is not wages for purposes of the social security tax. On the other hand, the value of meals and lodging that you must include in income (for example, meals and lodging not provided for your employer's convenience) is wages for purposes of the social security tax.

Meals provided without charge. Following are some situations in which you do not include in income meals provided to you without charge by your employer at your employer's place of business:

- Meals provided during your working hours in order to have you available for emergency calls during your meal period. However, you must show that emergencies have actually occurred or can be expected to occur, requiring your services during your meal period.
- Meals provided during your working hours because your employer's business is such that you must take a short meal period (30–45 minutes), and you cannot be expected to eat elsewhere in such a short time. For example, meals may qualify if there are not enough eating facilities near your place of work, or if you work in a business in which the peak workload occurs during the normal lunch hour. However, if the reason for the short meal period is to allow you to leave earlier, the meal will not qualify.
- Meals provided to you, as a food service employee, for each meal period in which you work, whether the meals are provided during, immediately before, or immediately after working hours. Thus, if you work as a waitress in a restaurant through the breakfast and lunch periods, you can exclude from income the value of breakfast and lunch provided in your employer's restaurant for each day you work.
- Meals provided to you after working hours that would have been provided to you during work hours for your employer's convenience, but because of your work duties you were prevented from eating during working hours.
- Meals provided to you, if your employer provides meals to employees at the place of business and the meals provided to almost all the employees are for the employer's convenience.

Meals provided with a charge. If your employer provides meals that you have a choice to buy or not, they do not meet the condition of being furnished for the convenience of your employer.

If your employer charges a flat fee for meals whether or not you accept the meals, you do not have to include the fee in income as compensation. However, if the meals are intended to give you extra pay and are not for your employer's convenience, you include the ***value*** of the meals (the flat fee unless shown otherwise) in income as compensation.

Meals provided on nonworkdays or with lodging. The value of meals provided on nonworkdays is income to you. However, if you are required to live at your employer's place of business as a condition of your employment, the value of ***any*** meal provided without charge at your employer's place of business is not income to you.

Meals provided to employees to promote goodwill, boost morale, or to make the business attractive to prospective employees are included in their incomes.

Lodging provided with or without a charge. If the three conditions (listed earlier) for excluding the value of lodging are met, that value is not included in your income, whether it is provided with or without a charge to you. Also, you do not include the value of lodging even though your employment contract or a law fixing the terms of your employment says that the lodging is provided as compensation.

If your employer charges you a flat fee for lodging whether or not you accept it, you do not have to include the fee in income as compensation. If all ***three*** conditions are met, you do not have to include in income the ***value*** of the lodging. If any one of those tests is not met, you must include the value of the lodging in income. Unless shown otherwise, the value of the lodging is the amount you are charged for it.

Faculty housing. If you are an employee of an educational institution and you (or your spouse and dependents) are provided qualified campus lodging for use as a residence, you must include in income the excess of the fair rental value of the housing over the amount of rent you pay.

Qualified campus lodging is lodging located on or near a campus of the educational institution. It also is lodging that you are not required to accept as a condition of your employment to properly perform the duties of your job.

Fair rental value. The amount of rent you pay for qualified campus lodging is considered the fair rental value if it is at least equal to the smaller of:

1) 5% of the appraised value of the lodging, or
2) The average of rentals paid by individuals (other than employees or students) for comparable housing held for rent by the educational institution.

If the amount you pay is less than the smaller of these amounts, you must include the difference in income.

The lodging must be appraised by an independent appraiser and the appraisal must be reviewed on an annual basis.

Example. Carl Johnson, a sociology professor for State University, rents a home from the university that is qualified campus lodging. The house is appraised at $100,000. The average rent paid for comparable university housing by persons other than employees or students is $7,000 a year. Carl pays an annual rent of $5,500. Carl does not include in income any rental value since the rent he pays equals at least 5% of the appraised value of the house (5% × $100,000 = $5,000). If Carl paid annual rent of only $4,000, he would have to include $1,000 in income ($5,000 − $4,000).

If you have a choice of either more pay, or meals or lodging, the value of the meals or lodging is income. However, you do not have income if you turn down meals that are offered to you and you are not given more pay in their place.

Reimbursements. If you receive a cash allowance or reimbursement from your employer for meals or lodging, you generally must include the

cash allowance or reimbursement in income as wages. Your employer will not withhold income tax from it, but will include it as other compensation on your Form W–2. Get Publication 463 for information on how to report reimbursements.

The examples that follow will help you determine if you must include in income the value of meals or lodging provided to you by your employer.

Example 1—meals. A waitress who works from 7 a.m. to 4 p.m. is provided, without charge, two meals a workday. The employer encourages, but does not require, the waitress to have her breakfast on the business premises before starting work. She is required to have her lunch on the premises. Because the waitress is a food service employee and works during the normal breakfast and lunch periods, the value of her breakfast and lunch ***is not income.***

Example 2—meals. The waitress in example (1) is allowed to have meals on the employer's premises without charge on her days off. She also receives, without charge, her evening meals on days she works. The value of these meals ***is income*** and must be reported as wages.

Example 3—meals. A bank teller who works from 9 a.m. to 5 p.m. is provided lunch without charge in a cafeteria the bank maintains on its premises. The bank gives the teller these meals to limit the lunch period to 30 minutes, because the bank's peak workload occurs during the normal lunch period. If the teller had to get lunch elsewhere, it would take considerably longer than 30 minutes. The value of these meals ***is not income.***

Example 4—meals. A hospital maintains a cafeteria on its premises where all its 230 employees can eat during their working hours. No charge is made for these meals. The hospital provides meals to have each of 210 of the employees available for emergencies. It is shown that each employee is at times called on to perform services during meal periods. Although the hospital does not require these employees to remain on the premises during meal periods, they rarely leave the hospital during their meal periods. Because the hospital provides meals to substantially all its employees to have each of them available for emergency call during meal periods, the meals ***are not income*** to any of the employees who eat in the hospital cafeteria.

Example 5—meals and lodging. A civil service employee of a state works at an institution and is required to be available for duty at all times. The employer provides the employee with meals and lodging at the institution without charge. Under the applicable state law, meals and lodging are regarded as part of the employee's pay. However, the value of this employee's meals and lodging ***is not income.***

Example 6—meals and lodging. A construction worker works at a remote job site in Alaska. Because of the inaccessibility of facilities and prevailing weather conditions, food and lodging is unavailable to the employees working at the job site. Therefore, the employer is required to provide meals and lodging to the employee at the camp site in order to carry on the construction project. The employee is required to pay $40 a week (deducted from wages) for the meals and lodging. The weekly charge of $40 is not included in the employee's income and the value of the meals and lodging is ***not*** income.

Example 7—lodging. An employee of an institution is given the choice of living at the institution free of charge, or living elsewhere and receiving a cash allowance in addition to regular salary. If the employee chooses to live at the institution, the value of the lodging provided the employee ***is income*** and must be reported as wages, because living at the institution is not a condition of employment.

A partner is not an employee of the partnership and the preceding rules regarding meals and lodging do not apply to a partner. The value of meals and lodging must be included in the income of the partner receiving them.

Other Fringe Benefits

Other fringe benefits you receive may be excluded from income.

Cafeteria plans. Cafeteria plans are separate written plans that allow participants (who must be employees) to choose among two or more benefits consisting of cash and qualified benefits. A "qualified benefit" includes any benefit that is not currently taxable to the participant upon receipt (such as group-term life insurance up to $50,000, coverage under an accident or health plan, and coverage under a dependent care assistance program).

The only taxable benefit that a cafeteria plan can offer is cash. Any qualified (nontaxable) benefit can be used in a cafeteria plan, other than scholarships and fellowship grants, educational assistance programs, and the fringe benefits (other than *Meals and Lodging*) previously discussed. Nontaxable benefits include group-term life insurance that is included in gross income only because the amount of the insurance exceeds $50,000 or the insurance is on the life of the employee's spouse or children.

A participant is not considered to have received a taxable benefit from a cafeteria plan simply because the participant can choose among the benefits of the plan.

Nondiscrimination rules. A cafeteria plan cannot discriminate in favor of highly compensated participants as to eligibility to participate in the plan or as to contributions or benefits. If the plan does discriminate, highly compensated participants must include in income the value of the benefits that could have been elected.

If qualified benefits provided to key employees are more than 25% of the total of these benefits provided for all employees under the plan, key employees must include in income the value of the benefits that could have been elected.

The taxable benefits are treated as having been received or accrued in the highly compensated participant's or key employee's tax year in which the plan year ends.

Dependent care assistance. If your employer provided you with child care or disabled dependent care services to allow you to work, you can exclude the amount of this benefit from income within certain limits. The amount you can exclude is limited to the smaller of:

1) Your earned income.
2) Your spouse's earned income.
3) $5,000 ($2,500 if married filing separately).

To exclude this benefit from income (and include any amount that exceeds the limit) see *How to report*, later.

Note. Overnight camp expenses paid by your employer from a qualified plan cannot be excluded as dependent care assistance. Also, the amount you can exclude from income reduces the dollar limit on work-related expenses you can use to figure your child and dependent care credit. For more information, get Publication 503, *Child and Dependent Care Expenses.*

For purposes of the earned income limit (see list above), if your spouse is a full-time student or incapable of self-care, your spouse will be considered to have earned $200 a month if you receive care for one dependent, or $400 a month if you receive care for two or more dependents.

If your dependent is cared for at your employer's place of business, the amount you can exclude from income is based on how often you use the facility and the value of the services.

The dependent care assistance must be provided under a separate written plan of your employer that does not favor highly compensated employees, and that meets other qualifications. Your employer can tell you if the plan qualifies for the exclusion.

How to report. To exclude the correct amount of dependent care benefits you received and include in income any taxable part of the benefits, complete and attach to your return the appropriate form for *Child and Dependent Care Expenses.* Attach Form 2441 to Form 1040 or Part 1 of Schedule 1 to Form 1040A. Do not file Form 1040EZ to report dependent care amounts.

When you complete the child and dependent care expenses form, be sure to give the dependent care provider's name, address, and identification number.

Educational assistance. You generally must include in income as wages any amount your employer paid for educational expenses for you.

Exception. If the educational courses are required by your employer or are job-related, and your employer either pays the expenses directly to the educational organization or reimburses you for the expenses after you make a full accounting, you may not have to include in income the amount paid by your employer.

In other cases you may be able to deduct the expenses under the rules explained in Publication 508, *Educational Expenses.* You must include in income monthly stipends paid by your employer to you when you are on educational leave.

Educational assistance program. An educational assistance program is a separate written plan of an employer to provide educational assistance to employees. The exclusion for educational assistance provided under this type of plan is no longer available.

Caution: As this publication was being prepared for print, Congress was considering legislation that would extend the exclusion for amounts received as educational assistance from your employer under a qualified plan. For information on any late legislative changes, get Publication 553, *Highlights of 1989 Tax Changes.*

Qualified tuition reductions. If you receive a qualified tuition reduction (QTR), it is not included in income. A QTR is the amount of reduction in tuition for education (below the graduate level) furnished by an educational institution to an employee (or a person treated as an employee or certain other individuals) provided certain requirements are met. However, graduate students who engage in teaching or research activities for the educational institution may qualify for this exclusion. For more information get Publication 520, *Scholarships and Fellowships.*

Employer-provided transportation. The value of employer-provided transportation, such as a vanpool or similar shared-usage arrangement, must be included in the gross income of each employee, including the driver, who commutes in the employer-provided vehicle.

Executive health program. Amounts an employer pays for a health reconditioning and restoring service provided to one of its executives at a resort hotel or athletic club are included in the executive's compensation.

Financial counseling fees paid by a corporation for its executives are included in the executives' gross income and must be reported as part of wages. If the fees are for tax or investment counseling, they can be deducted by the executive as a miscellaneous deduction subject to the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040).

Group legal services plan. The exclusion for amounts paid by your employer for your participation in a qualified group legal services plan is no longer available.

Medical insurance premiums paid for you, your spouse, and your dependents by your employer (former employer if you are retired) under a qualified employer plan are not included in income. This includes supplemental medical insurance (Medicare). You continue to be an employee during a layoff period for purposes of this benefit.

If your employer reimburses you for health insurance premiums after you verify you paid the premiums, the reimbursement is not included in income. Premiums paid by an employer for the benefit of a deceased employee's surviving spouse and dependents are also not included in income.

Taxation of Certain Fringe Benefits

Fringe benefits you receive in connection with the performance of your services are included in gross income as compensation unless you pay fair market value for them or they are specifically excluded from income. Abstaining from the performance of services (for example, under a covenant not to compete) is treated as the performance of services for purposes of these rules.

Recipient of benefit. You are the recipient of a fringe benefit if you perform the services for which the fringe benefit is provided. Therefore, you are considered to be the recipient even if you did not actually receive the fringe benefit. For example, a fringe benefit provided to another person, such as a member of your family, for services you perform is considered to have been provided to you and not the person who received the fringe benefit.

You do not have to be an employee of the provider to be a recipient of a fringe benefit. If you are a partner, director, or independent contractor, you can also be the recipient of a fringe benefit.

Provider of benefit. Your employer or another person for whom you perform services is the provider of a fringe benefit regardless of whether that person actually provides the fringe benefit to you. The provider can be, for example, a client or customer of an independent contractor.

Valuation of fringe benefits. You must include in gross income the amount by which the fair market value of the fringe benefit is greater than the sum of:

1) The amount, if any, you paid for the benefit, and
2) The amount, if any, specifically excluded from gross income.

Therefore, if you pay fair market value for a fringe benefit, no amount is included in your gross income.

Fair market value. In general, the fair market value of a fringe benefit is determined on the basis of all the facts and circumstances. Specifically, the fair market value of a fringe benefit is the amount you would have to pay a third party to buy or lease the particular fringe benefit. In determining the value of the fringe benefit:

1) Your perceived value of the benefit is not relevant.
2) The amount your employer paid for the benefit is not a determining factor.

General valuation rules. If you do not use the special valuation rules, you must determine the value of employer-provided vehicles and flights on employer-provided aircraft under the general valuation rules.

Employer-provided vehicles. In general, the value of an employer-provided vehicle is the amount you would have to pay a third party to lease the same or a similar vehicle in the same geographic area where you use the vehicle. The value cannot be determined by multiplying the cents-per-mile rate times the number of miles driven unless you prove the vehicle could have been leased on a cents-per-mile basis. A comparable lease term would be the amount of time the vehicle is available for your use, such as a one-year period.

Flights on employer-provided aircraft. Under the general valuation rules, if your flight on an employer-provided aircraft is primarily personal and you control the use of the aircraft for the flight, the value is the amount it would cost to charter the flight from a third party.

If there is more than one employee on the flight, the cost to charter the aircraft must be divided among those employees. The division must be based on all the facts, including which employee or employees controlled the use of the aircraft.

Special valuation rules may be used instead of the general valuation rule. Use of any of the special valuation rules is optional. You can only use a special valuation rule if your employer uses the rule, and you cannot use another special rule to value that benefit. You can, however, use the general valuation rules previously discussed, based on facts and circumstances. The special valuation rules are:

1) Automobile lease valuation rule.
2) Vehicle cents-per-mile valuation rule.
3) Commuting valuation rule.
4) Meal valuation rule.

For more information on these rules, get Publication 535.

For information on the non-commercial flight and commercial flight valuation rules, see sections 1.61–21(g) and 1.61–21(h) of the Income Tax Regulations.

How to Report Fringe Benefits

The amount of your taxable fringe benefits is shown on your Form W–2.

Different valuation by employer and employee. You and your employer can compute a different value for an employer-provided automobile. The following combinations of methods may be used:

1) You and your employer can both use the same special valuation rule.
2) Your employer can use a special valuation rule and you can use the general valuation rule based on facts and circumstances.
3) You and your employer can both use the general valuation rule.

If both you and your employer use the same special valuation rule, you must include in gross income the amount your employer determines under the special rule.

In situations (2) or (3) you can compute a value which is different from your employer's value and include that amount in income. You will report on Form 1040 a different amount as compensation than your employer reports on your Form W–2. Enter the amount of your compensation, including the value of your fringe benefits as you computed them using your method of valuation, on line 7, Form 1040A, or line 7, Form 1040. Write "FB" in the margin to the left of the line. Attach a statement to your return explaining which method you used and how you figured your valuation of these fringe benefits.

Employer-provided car. If your employer provides a car (or other highway motor vehicle) to you, your personal use of the car is a taxable noncash fringe benefit. Your employer must determine the actual value of this fringe benefit to include in income. This value can be determined by either of the following methods:

1) The actual value of your personal use of the car, or
2) The value of the car as if you used it entirely for personal purposes (100% income inclusion).

If your employer includes 100% of the value in income, you can deduct the value of your business use of the car. You figure the value of this business use on Form 2106, *Employee Business Expenses.*

Accounting period. You must use the same accounting period your employer uses to report your taxable fringe benefits. Your employer has the option to report taxable fringe benefits by either of the following rules:

1) The general rule: value the benefit for a full calendar year (January 1–December 31), or
2) The special accounting period rule: treat the value of benefits provided during the last 2 months of the calendar year (or any shorter period) as paid during the following calendar year:
   a) Each year your employer includes in income the value of benefits provided the last 2 months of the prior year and the first 10 months of the current year.
   b) You must use the same accounting period to claim an employee business deduction (for use of a car, for example).

Your employer does not have to use the same accounting period for each fringe benefit, but is required to use the same period for all employees who receive a particular benefit. For more information, get Publication 917.

Form W–2. Your employer reports your taxable fringe benefits in Box 10 (Wages, tips, other compensation) and, if applicable, Box 13 (Social security wages) of Form W–2, *Wage and Tax Statement.* The total value of your fringe benefits should also be noted in Box 16a. The value of your fringe benefits may be added to your other compensation on one Form W–2, or you may receive a separate Form W–2 showing just the value of your fringe benefits in Box 10 with a notation in Box 16a.

Disability Income

Generally, if you retire on disability you must report your pension or annuity as income. However, there is a tax credit for people who are permanently and totally disabled. For information on this credit and the definition of permanent and total disability, get Publication 524, *Credit for the Elderly or the Disabled.*

Disability Pensions

Generally, you must report as income any amount you receive for your disability through an accident or health insurance plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive for your disability that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you. Your employer should be able to give you specific details about your pension plan and tell you the amount you paid for your disability pension.

If you pay the entire cost of a health or accident insurance plan, do not include any amounts you receive for your disability as income on your tax return. If your plan reimbursed you for medical expenses you deducted in an earlier year, you may have to include some, or all, of the reimbursement in income. Get Publication 502, *Medical and Dental Expenses.*

Accrued leave payment. If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. Include it in gross income in the tax year you receive it.

Retirement and profit-sharing plans. Any payments you receive from a retirement or profit-sharing plan that does not provide for disability retirement are not payments from an accident or health plan. Therefore, do not report them as disability income. The payments are taxable and should be reported as a pension or annuity.

For more information on pensions in general, get Publication 575.

How to report. If you retired on disability, payments you receive are taxable as wages until you reach minimum retirement age. Minimum retirement age generally is the earliest age at which you can receive a pension or annuity whether or not you are disabled. You must report your taxable disability payments as wages on line 7, Form 1040, until you reach minimum retirement age.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension. Report the payments on line 17, Form 1040. For more information on pensions, get Publication 575.

Death benefit exclusion. If you are the survivor of a deceased employee who retired on disability and died before reaching minimum retirement age, you may qualify for the death benefit exclusion. For more information on the death benefit exclusion, see *Payments to beneficiaries of deceased employees (death benefit exclusion)* under *Life Insurance Proceeds*, later. Also, get Publication 575.

Military and Government Disability Pensions

Generally, you must report disability pensions as income. But certain military and government disability pensions are not taxable.

Members of government services. Generally, you must include in income any disability payments you receive for personal injury or sickness resulting from active service in the:

1) Armed Forces of any country.
2) National Oceanic and Atmospheric Administration.
3) Public Health Service.
4) Foreign Service.

However, if you receive a disability pension based on percentage of disability, do not include the disability payments in income if any of the following apply:

1) You were entitled to receive a disability payment before September 25, 1975.
2) You were a member of a government service or its reserve component, or were under a binding written commitment to become a member, on September 24, 1975.
3) You receive disability payments for a "combat-related injury."
4) You would be entitled to receive disability compensation from the Department of Veterans Affairs if you filed an application for it.

Combat-related injury means personal injury or sickness that:

1) Results directly from armed conflict,
2) Takes place while you are engaged in extra-hazardous service,
3) Takes place under conditions simulating war, including training exercises such as maneuvers, or
4) Is caused by an instrument of war.

Disability based on years of service. If you receive a disability pension based on years of service, you generally must include it in income. But if you fall into one of the 4 categories listed under *Members of government services*, do not include in income the part of your pension that you would have received if the pension had been based on percentage of disability. You must include the rest of your pension in income.

Government employee. You do not include in income disability payments you receive for injuries resulting directly from a violent attack that occurs while you are a U.S. government employee performing official duties outside the United States. For your disability payments to be tax exempt, the Secretary of State must determine the attack was a terrorist attack.

Disability benefits you receive from the Department of Veterans Affairs are not included in gross income. If you are a military retiree and do not receive disability benefits from the VA, do not include in income the amount of disability benefits equal to the VA benefits to which you are entitled.

If you retire from the armed services (based on years of service) and at a later date are given a retroactive service-connected disability rating by the VA, you do not include in income for the retroactive period the part of your retirement pay you would have been entitled to receive from the VA during that period. However, you must include in income any lump-sum readjustment payment you received on release from active duty, even though you are later given a retroactive disability rating by the VA.

Other Sickness and Injury Benefits

In addition to disability pensions and annuities, you may receive other payments for sickness and injury.

Railroad sick pay. If you receive sick pay under the Railroad Unemployment Insurance Act, these payments are taxable and you must include them in income. However, you do not have to include them in income to the extent they are for an on-the-job injury.

Workers' compensation you receive for sickness or injury is fully exempt from tax until you reach retirement age (as defined under *Group Life Insurance Premiums*, earlier). Workers' compensation payments to your beneficiaries in case of your death before you reach retirement age are also exempt.

Note. If part of your workers' compensation reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable.

For a discussion of the taxability of these benefits, see *Social security and equivalent railroad retirement benefits* later.

If you return to work after qualifying for workers' compensation, payments you continue to receive while assigned to light duties are taxable.

Part of your disability pension may be workers' compensation. That part is exempt from tax. The rest of your pension, based on years of service, is taxable as pension or annuity income. If you die, the part of your survivor's benefit that is a continuation of the workers' compensation is exempt from tax.

Black lung benefit payments are similar to workers' compensation and generally are not taxable.

Federal Employees' Compensation Act (FECA) payments for personal injury or sickness, including payments to beneficiaries in case of death, are not taxable. However, you are taxed on amounts you receive under this Act as "continuation of pay" for up to 45 days while a claim is being decided. Also, pay for sick leave while a claim is being processed is taxable.

You can deduct the amount you spend to "buy back" sick leave for an earlier year to be eligible for nontaxable FECA benefits for that period. It is a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040). If you "buy back" sick leave in the same year you used it, the amount reduces your taxable sick leave pay. Do not deduct it separately.

Other compensation. Many other amounts you receive as compensation for injury or illness are not taxable. These include:

Compensatory damages you receive for injury or illness, whether paid in a lump sum or in periodic payments (however, punitive damages are taxable);

Benefits you receive under an accident or health insurance policy attributable to premiums you paid;

Disability benefits you receive for loss of income or earning capacity as a result of injuries under a "no-fault" car insurance policy; and

Compensation you receive for permanent loss or loss of use of a part or function of your body, or for your permanent disfigurement. This compensation must be figured only with regard to the injury and not to your period of absence from work. These benefits are not taxable even though your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care is generally not taxable. However, this reimbursement may reduce your medical expense deduction. For more information, see *Recoveries*, later.

Stock Options

If you receive a nonstatutory option to buy stock or other property as payment for your services, you will usually have income when you receive the option or when you exercise the option. However, if your option is a statutory stock option—an incentive stock option or an option granted under an employee stock purchase plan—special rules generally postpone the tax until you sell or exchange your shares of stock.

Nonstatutory Stock Options

If you are granted a nonstatutory stock option, the time and amount of income to include depend on whether the option has a readily determined fair market value. The fair market value of an option normally is readily determined only if:

1) It is actively traded on an established market, or
2) It is freely transferable, exercisable immediately in full, and not subject to any condition or restriction.

If you receive a nonstatutory stock option that has a readily determined fair market value at the time it is granted to you, the option is treated like other property received as compensation. See *Restricted Property Received for Services*, earlier, for rules on how much income to include, when to include it, and how you may choose to include income in the year of the transfer.

If the fair market value of the option is not readily determined, you do not have income until you transfer or exercise the option. When you exercise this kind of option, the amount to include in income is the difference between the amount you pay for the property and its fair market value at the time you have an unconditional right to receive it.

However, if you acquire the property under an option granted to you after April 21, 1969, you cannot transfer the property, and you have a chance of losing it, you do not include this amount in income until you can transfer the property or you no longer have a good chance of losing it.

Your basis in the property you acquire under the option is the amount you pay for it plus any amount you must include in gross income under this rule. For more information on restricted property, see *Restricted Property Received for Services*, earlier.

If you transfer this kind of option in an arm's-length transaction, you must include in income the money or other property you received for the transfer, as if you had exercised the option.

Statutory Stock Options

There are two kinds of statutory stock options:

1) Incentive stock options.

2) Options granted under employee stock purchase plans.

In each case, you must be an employee of the company granting the option, or a related company, at all times beginning with the date of the grant of the option, until 3 months before you exercise the option (for an incentive stock option, 1 year before if you are disabled). Also, the option must be nontransferable except at death.

Your employer can tell you what kind of option you hold. If you exercise an incentive stock option, your employer will give you a statement containing the required information. A discussion of the tax treatment of incentive stock options and employee stock purchase plans follows.

Incentive stock options. If your option is an incentive stock option, generally you have no income tax liability either at the time the option is granted or at the time you exercise it. You report income or loss when you sell the stock you purchased by exercising the option.

Tax treatment. You generally treat income or loss from the sale of the stock as capital gain or loss. However, if you do not meet the holding period tests explained next, you may have ordinary income up to the amount of the gain.

Holding period. If you hold the stock you buy under the option for more than 1 year after the stock is transferred to you, and more than 2 years after the option was granted to you, gain or loss from the sale of the stock is generally a capital gain or loss. The difference between the amount you pay for the stock (the option price) and the amount you receive when you sell it is a capital gain or loss reported on Schedule D (Form 1040).

If you do not meet these holding period tests, you have ordinary income in the year you sell the stock. That income is the amount by which the stock's fair market value, as of the date you exercise the option, is more than the option price. However, this amount cannot be more than your gain on the sale. Any excess of your gain over the amount you report as ordinary income is capital gain reported on Schedule D (Form 1040). If you sell the stock for less than the option price, your loss is a capital loss.

Example. Your employer, X Corporation, granted you an incentive stock option on March 11, 1987, to buy 100 shares of X Corporation stock at $10 a share, its fair market value at the time. You exercised the option on January 15, 1988, when the stock was selling on the open market for $12 a share. On January 20, 1989, you sold the stock for $15 a share. Although you held the stock for more than a year, less than 2 years had passed from the time you were granted the option. In 1989, you must report the difference between the option price ($10) and the value of the stock when you exercised the option ($12) as ordinary income. The rest of your gain is capital gain.

Selling price ($15 × 100 shares)	$1,500
Purchase price ($10 × 100 shares)	1,000
Gain	$ 500
Amount reported as ordinary income ($1,200 minus $1,000)	200
Amount reported as capital gain	$ 300

Alternative minimum tax. For options exercised after December 31, 1987, the time has changed for reporting income from a stock option for purposes of the alternative minimum tax. When your rights in the stock are transferable and no longer subject to a substantial risk of forfeiture, you must include as an adjustment in figuring alternative minimum taxable income the amount by which the fair market value of the stock exceeds the option price.

See *Restricted Property Received for Services*, for more information on substantially vested property.

For information on the alternative minimum tax get Publication 909, *Alternative Minimum Tax for Individuals*.

Employee stock purchase plans. If your stock option is granted under an employee stock purchase plan, you do not have to include any amount in gross income as a result of the grant or exercise of your option. You report income or loss when you sell the stock that you purchased by exercising the option.

Tax treatment. You generally treat gain or loss from the sale of the stock as capital gain or loss. However, you may have ordinary income if:

1) The option price of the stock was below the stock's fair market value at the time the option was granted, or
2) You did not meet the holding period requirement explained next.

Holding period. You must hold the stock for more than 2 years from the time the stock option is granted to you and for more than one year (6 months for stock purchased before January 1, 1988) from when you purchased it.

If you meet the holding period requirement and the option price was below the fair market value of the stock at the time the option was granted, you report the difference as ordinary income (wages) when you sell the stock. However, this ordinary income cannot be more than your gain on the sale. If your gain is more than the amount you report as ordinary income, the remainder is a capital gain reported on Schedule D (Form 1040). If you sell the stock for less than the option price, your loss is a capital loss.

Example. Your employer, Y Corporation, granted you an option to buy 100 shares of stock of Y Corporation for $20 a share, at a time when the stock had a value of $22 a share. Eighteen months later, when the value of the stock was $23 a share, you exercised the option, and 14 months after that you sold your stock for $30 a share. In the year of sale, you must report as ordinary income the difference between the option price ($20) and the value at the time the option was granted ($22). The rest of your gain ($8) is capital gain.

Selling price ($30 × 100 shares)	$3,000
Purchase price (option price) ($20 × 100 shares)	2,000
Gain	$1,000
Amount reported as ordinary income ($2,200 − $2,000)	200
Amount reported as capital gain	$ 800

If you do not meet the holding period requirement, you must report as ordinary income the difference between the option price and the fair market value of the stock when you exercised the option.

This ordinary income is reported on line 7, Form 1040, even if it is more than your total gain. Increase your basis in the stock by the amount you report as ordinary income. The difference between your increased basis and the selling price is a capital gain or loss reported on Schedule D (Form 1040).

In the previous example, if you had not held the stock long enough your ordinary income would be $300, and your capital gain would be $700, figured as follows:

Selling price ($30 × 100 shares)	$3,000
Purchase price (option price) ($20 × 100 shares)	2,000
Gain	$1,000
Amount reported as ordinary income ($2,300 − $2,000)	300
Amount reported as capital gain	$ 700

Special Rules for Certain Employees

This part of the publication deals with special rules for people in certain types of employment: members of the clergy, people working for foreign employers, military personnel, veterans, and ACTION and Peace Corps volunteers.

Clergy

If you are a member of the clergy, you must include in income offerings and fees you receive for marriages, baptisms, funerals, masses, etc., in addition to your salary. If the offering is made to the religious institution, it is not taxable to you.

If you are a member of a religious organization and turn over your outside earnings to the organization, you nonetheless must include the earnings in income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization. Get Publication 526, *Charitable Contributions*. Also, see *Members of religious orders*, later.

Housing

Special rules for housing apply to members of the clergy.

Rental value of a home. You do not have to include in income the rental value of a home (or utility expenses) provided to you as part of your pay for your duties as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home, and related allowances, as earnings from self-employment on Schedule SE (Form 1040) for purposes of the social security self-employment tax.

A housing allowance paid to you as part of your salary is not income to the extent you use it, in the year received, to provide a home or to pay utilities for a home you are provided. The amount of the housing allowance you can exclude from income cannot be more than the reasonable compensation for your services as a minister. The church or organization that employs you must officially designate the payment as a housing allowance before the payment is made. A definite amount must be designated; the amount of the housing allowance cannot be determined at a later date.

If you are employed and paid by a local congregation, a resolution by a national church agency of your denomination does not effectively designate a housing allowance for you. The local congregation must officially designate the part of your salary that is to be a housing allowance. However, a resolution of a national church agency can designate your housing allowance if you are directly employed by the agency. If no part has been officially designated, you must include your total salary in income.

Expenses of providing a home include rent, house payments, furniture payments, costs for a garage, and utilities. They do not include the cost of food or servants.

If you own your home, or are buying it, you can exclude your housing allowance from income if you spend it for the down payment on the home, for mortgage payments, or for interest, taxes, utilities, repairs, etc. However, you cannot exclude more than the fair rental value of the home plus the cost of utilities, even if a larger amount is designated as a housing allowance. Fair rental value of a home includes the fair rental value of furnishings in it.

Interest and taxes on your home. You can deduct the mortgage interest and real estate taxes you pay on your home even if you use nontaxable housing allowance funds to make the payments.

Teachers or administrators. If you are a minister employed as a teacher or administrator by a church school, college, or university, you are performing ministerial services for purposes of the rental exclusion. However, if you perform services as the head of a religious department, or as a teacher or administrator on the faculty of a nonchurch college, and if your specific duties involve no religious functions, you cannot exclude from income a rental allowance or the value of a home that is provided to you. However, if you live in qualified campus housing as an employee of an educational institution, you do not have to include the value of that housing in income if you pay rent equal to or greater than the fair rental value of the housing. See *Faculty housing*, discussed earlier.

If you serve as a "minister of music" or "minister of education," or serve in an administrative or other function of your religious organization, but are not authorized to perform all of the religious duties of an ordained minister in your church (even though commissioned as a "minister of the gospel"), you cannot exclude from income a rental allowance or the value of a home provided to you.

Theological students. You cannot exclude a rental allowance from income if you are a theological student serving a required internship as an assistant pastor unless you are ordained, commissioned, or licensed as a minister.

Traveling evangelists. If you are an ordained minister and are providing evangelistic services, you can exclude amounts received from out-of-town churches that are designated as rental allowance, provided you actually use them to maintain your permanent home.

If you are a Jewish cantor, you can exclude a rental allowance from gross income although you are not ordained, provided you have a bona fide commission, and are employed by a congregation on a full-time basis to perform substantially all the religious functions of the Jewish faith.

Retired members of the clergy. The rental value of a home provided rent free by your church for your past services is not income if you are a retired minister. In addition, a housing allowance paid to you is not income to the extent you spend it for utilities, maintenance, repairs, and similar expenses directly related to providing a home.

The general convention of a national religious denomination can designate a housing allowance for retired ministers, if the local congregations authorize the general convention to establish and maintain a unified pension system for all retired clergy members of the denomination for their past services to the local churches.

A surviving spouse of a retired minister cannot exclude a housing allowance from income. It must be reported on line 17, Form 1040.

A pension or retirement pay for a member of the clergy is usually treated as any other pension or annuity and must be reported on line 17, Form 1040. If you are not expected to perform any further services, payments from the congregation may be gifts. They are not taxable if they are based solely on your financial needs and the financial capacity of the congregation. If these payments are made under a legal agreement, an established plan, or because of past practice, they do not qualify as nontaxable gifts.

Members of religious orders. If you are a member of a religious order who has taken a vow of poverty, the amounts you earn for services you perform which you renounce and turn over to the order may or may not be included in income. If you are performing the services as an agent of the order in the exercise of duties required by the order, you do not include in income the amounts turned over to the order.

Services performed for the order. If your order directs you to perform services for another agency of the supervising church, or an associated institution, you are considered to be performing the services as an agent of the order. Any wages you earn as an agent of an order which you turn over to the order are not included in gross income.

Example. You are a member of a church order and have taken a vow of poverty. You renounce any claims to your earnings and turn over to the order any salaries or wages you earn. You are a registered nurse, so your order assigns you to work in a hospital that is an associated institution of the church. However, you remain under the general direction and control of the order. You are considered to be an agent of the order and, therefore, any wages you earn at the hospital which you turn over to your order are not included in your gross income.

Services performed outside the order. If you are directed to take employment outside the order, the employment will not constitute the exercise of duties required by the order unless the services you perform meet both the following requirements:

1) The services are the kind that are ordinarily the duties of members of the order.
2) The services are part of the duties that are required to be exercised for, or on behalf of, the religious order as its agent.

If the legal relationship of employer and employee exists between you and a third party, the services you perform for the third party will not be considered directed or required of you by the order. Amounts you receive for these services are included in gross income, even if you have taken a vow of poverty.

Example 1. Mark Brown is a member of a religious order and has taken a vow of poverty. All claims to his earnings are renounced and the earnings belong to the order.

Mark is a school teacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school. Mark became an employee of the school, and, at his request, the school made the salary payments directly to the order.

Because Mark is an employee of the school, he is performing services as the school's agent rather than as an agent of the order. Therefore, the wages Mark earns working for the school are included in his gross income.

Example 2. Gene Dennis is a member of a religious order who, as a condition of membership, has taken vows of poverty and obedience. All claims to his earnings are renounced. Gene received permission from the order to establish a private practice as a psychologist and counsels members of religious orders as well as nonmembers. Although the order reviews Gene's budget annually, Gene controls not only the details of his practice but also the means by which his work as a psychologist is accomplished. Gene's private practice as a psychologist does not make him an agent of the religious order. The psychology services provided by Gene are not the type of services that are provided by the order. The income Gene earns as a psychologist is earned in his individual capacity. Therefore, Gene must include in income the earnings from his private practice.

Foreign Employer

Special rules apply if you work for a foreign employer.

U.S. citizen. If you are a U.S. citizen who works in the United States for a foreign government, an international organization, a foreign embassy, or any foreign employer, you must include your salary in income.

Social security tax. You are exempt from social security employee tax if you are employed in the United States by an international organization or a foreign government. However, you must pay social security self-employment tax on your earnings from services performed in the United States, even though you are not self-employed. This rule also applies if you are an employee of a qualifying wholly-owned instrumentality of a foreign government.

Non-U.S. citizen. If you are not a U.S. citizen, or if you are a U.S. citizen but also a citizen of the Philippines, and you work for an international organization in the United States, your salary from that source is exempt from tax. If you work for a foreign government in the United States, your salary from that source is exempt from tax if your work is like the work done by an employee of the United States in that foreign country and if the foreign government gives an equal exemption for the salary of the U.S. employee.

Alien status. If you are an alien and give up your right to this exemption (by filing a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status), you are not entitled to the exemption from the date you give it up, unless you get the exemption from a treaty, consular agreement, or international agreement.

Pensions. This exemption applies only to employees' wages, salaries, and fees. Pensions received by former employees living in this country do not qualify for this exemption.

Employment abroad. For information on income earned abroad, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

Military

Payments you receive as a member of a military service generally are taxable as wages except for retirement pay, which is taxable as a pension. Allowances generally are not taxable.

Taxable Income

Taxable income includes the following items.

Wages. Military pay taxable as wages includes:

- Active duty pay
- Reserve training pay
- Reenlistment bonuses
- Armed services academy pay
- Amounts received by retired personnel serving as instructors in junior ROTC programs
- Lump-sum payments on separation or release from active duty
- Student loan repayments from the General Educational Loan Repayment Program

Military retirement pay, based on age or length of service, is taxable and must be included in gross income as a pension on line 17, Form 1040. Do not include in income the amount of reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

For a more detailed discussion of survivor annuities, get Publication 575.

If you retire on disability, see *Military and Government Disability Pensions* under *Disability Income*, earlier.

Nontaxable Income

Qualified military benefits you receive are not taxable. These benefits include:

- Annual round trip for dependent students
- Burial and death services (interment allowances)

- Combat zone compensation and combat-related benefits
- Death gratuities
- Defense counseling
- Dental care for military dependents
- Dependent education
- Disability benefits
- Educational assistance
- Emergency assistance
- Evacuation allowances
- Family counseling
- Family separation allowances
- Forfeited pay
- Group-term life insurance
- Housing allowances
- Medical benefits
- Moving and storage
- Mustering out payments (payments on discharge)
- Overseas cost-of-living allowances
- Premiums for survivor and retirement protection plans
- Professional education
- Quarters allowances
- Subsistence allowances
- Temporary lodging in conjunction with certain orders
- Travel for consecutive overseas tours
- Travel for consecutive overseas tours for dependents
- Travel in lieu of moving dependents during ship overhaul or inactivation
- Travel of dependents to a burial site
- Travel to a designated place in conjunction with reassignment in a dependant-restricted status
- Uniform allowances

Note. Personal use of a vehicle cannot be excluded from income as a qualified military benefit.

Income taxes of certain military and civilian employees. If a United States military or civilian employee dies as a result of wounds or injuries incurred after November 17, 1978, the decedent's federal income tax liability is forgiven if the decedent was:

1) Wounded or injured in a terrorist or military action outside the U.S.,
2) A U.S. military or civilian employee when wounded or injured, and
3) A U.S. military or civilian employee when death occurred.

The income tax is forgiven for the year of death and for any prior tax year beginning with the year before the year the wounds or injuries were incurred. For more information, see *Income Taxes of Certain Members of the Armed Forces on Death* in Publication 559.

For more information on military allowances and benefits, get Publication 3, *Tax Information for Military Personnel.*

Veterans

Veterans' benefits generally are not taxable.

Nontaxable Income

Veterans' benefits under any law administered by the Department of Veterans Affairs are not included in gross income. The following amounts paid to veterans or their families are not taxable:

- Education, training, or subsistence allowances.
- Disability compensation and pension payments for disabilities.
- Grants for homes designed for wheelchair living.
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- Veterans' pensions paid either to veterans or to their families.
- Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran's endowment policy paid before death.

Taxable Income

Certain amounts paid by the Department of Veterans Affairs (VA) are taxable.

Interest. Interest on dividends you leave on deposit with the VA is taxable. The amount of this interest is shown on the statement the VA gives you. If you decide to use accumulated dividends to buy additional paid-up National Service Life Insurance, neither the dividends nor the paid-up insurance is taxable.

Rehabilitative program payments. VA payments to hospital patients and resident veterans for their services under the VA's therapeutic or rehabilitative program are included as income other than wages on line 22, Form 1040.

Volunteers

The tax treatment of amounts you receive as a volunteer worker for the Peace Corps, ACTION, or similar agency is covered in the following discussions.

Peace Corps

If you are a Peace Corps volunteer or volunteer leader, some allowances you receive are taxable and others are exempt from tax.

Taxable allowances must be included in income and reported as wages. These include:

- Cash allowances received during training.
- Allowances paid to your spouse and minor children while you are training in the United States.
- The part of living allowances designated by the President under the Peace Corps Act as "basic compensation."
- Allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.
- Leave allowances.
- Readjustment allowances or "termination payments." These are considered received by you when credited to your account.

Example. Gary Carpenter, a Peace Corps volunteer, gets $175 a month during his period of service, to be paid to him in a lump sum at the end of his tour of duty. Although the allowance is not available to him until the end of his service, Gary must include it in his income on a monthly basis as it is credited to his account.

Nontaxable allowances include travel and living allowances for basic necessities such as: housing, utilities, food, clothing, and household supplies.

ACTION

ACTION participants perform services in antipoverty programs and Older American volunteer programs. Some amounts these participants receive are taxable and others are exempt from tax.

VISTA. If you are a VISTA volunteer, you must include in income meal and lodging allowances paid to you as wages.

University Year for Action program. If you receive a stipend as a full-time student for service in the University Year for Action program, you must include the stipend in income as wages.

Older American Programs. Do not include in income amounts you receive for supportive services or are reimbursed for out-of-pocket expenses from:

- Retired Senior Volunteer Program (RSVP)
- Foster Grandparent Program
- Senior Companion Program

Other Volunteer Programs

If you receive amounts for supportive services or are reimbursed for out-of-pocket expenses under any of the following volunteer programs, you do not include these amounts in gross income:

- Service Corps of Retired Executives (SCORE)
- Active Corps of Executives (ACE)

Volunteer tax counseling for the elderly. You do not include in income any reimbursements you receive for transportation, meals, and other expenses you have in training for, or actually providing, volunteer federal income tax counseling for the elderly (TCE).

You can deduct as a charitable contribution your unreimbursed out-of-pocket expenses in taking part in the volunteer income tax assistance (VITA) program.

Miscellaneous Taxable Income

You can receive taxable income from various sources. For example, income is treated as received from certain transactions, such as the cancellation of a debt. Under *Recoveries* is a discussion of when to include in income amounts you receive that you deducted in a prior year, such as a state income tax refund. In addition, *Repayments* discusses how you can deduct amounts you had to repay that you included in income in a prior year.

The following brief discussions of numerous income items are arranged in alphabetical order. Those that are discussed in greater detail in another publication include a reference to that publication. These discussions are followed by in-depth discussions of other taxable income items as shown in the Table of Contents.

Note. When you report miscellaneous taxable income on line 22 of Form 1040, write a brief description of the income on the dotted line next to line 22.

Activity not for profit. You must include on your return income from an activity from which you do not expect to make a profit. An example of this type of activity would be a hobby or a farm you operate mostly for recreation and pleasure. Deductions for expenses related to the activity are limited, cannot total more than the income you report, and can be taken only if you itemize deductions on Schedule A (Form 1040).

The activity will be presumed to have been for profit if it results in a profit in at least 3 out of 5 consecutive tax years. However, for the breeding, training, showing, or racing of horses, the activity must result in a profit in at least 2 out of 7 consecutive tax years. If the activity meets this test, it is presumed to be carried on for profit and the limits on the deductions will not apply.

If you have engaged in an activity for less than 3 years, you can postpone the determination that the activity is not for profit by filing Form 5213, *Election To Postpone Determination.* Get Publication 535 for more information.

Alaska oil royalties. If you qualified as a resident of Alaska and received a payment from Alaska's mineral income fund, you must report this amount on line 22, Form 1040. The state of Alaska will send you a Form 1099–MISC which

shows this amount. IRS will receive a copy of the Form 1099–MISC.

Alimony. Include in income on line 11, Form 1040, any alimony payments you receive. Amounts you receive from your former spouse for child support are not income to you. For complete information, get Publication 504, *Tax Information for Divorced or Separated Individuals.*

Allowances and reimbursements. If you receive travel, transportation, or other allowances or reimbursements from your employer, get Publication 463.

Below-market interest rate loan. A below-market loan is a loan on which no interest is charged or, if charged, is at a rate below the applicable federal rate. If you make a below-market loan, you must include as income the foregone interest (at the federal rate) from the loan. These loans are considered a transaction in which you, the lender, are treated as having made:

1) A loan to the borrower in exchange for a note which requires the payment of interest at the applicable federal rate, and
2) An additional payment to the borrower. Depending on the transaction, the payment is treated as a:
   a) Gift,
   b) Dividend,
   c) Contribution to capital,
   d) Payment of compensation, or
   e) Another type of payment.

The borrower may have to report this payment as income, depending upon its classification. For more information on below-market interest rate loans, get Publication 545, *Interest Expense.*

Cancellation of land sale contract. If you sell land under a contract, but the contract is cancelled and you return the buyer's money in the same tax year as the original sale, you have no income from the sale. However, if the contract is cancelled and you return the buyer's money in a later tax year, you must include your gain in income for the year of the sale. When you return the money and take back the land in the later year, you treat the transaction as a purchase which gives you a new basis in the land equal to the funds you return to the buyer. However, special rules apply to the reacquisition of real property where a secured indebtedness (mortgage) to the original seller is involved. For further information, see *Repossessions* in Publication 537, *Installment Sales.*

Cancelled debt. A cancelled debt, or a debt paid for you by another person, is generally income to you and must be reported on line 22, Form 1040. A discount offered by a financial institution for the prepayment of a mortgage loan is income from the cancellation of a debt. However, you have no income from the cancellation of a debt if the cancellation, or the payment by another person, is intended by the other person as a gift to you.

If your debt is cancelled in a bankruptcy case (title 11) or when you are insolvent, the discharge of indebtedness is not income. Also, a cancelled qualified farm debt is excluded from income even if the farmer owing the debt is solvent.

If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the cancelled debt is dividend income to you.

For more information on cancelled debts and the limits on the amount that can be excluded from income, get Publication 908, *Bankruptcy and Other Debt Cancellation.*

Cancellation of student loan. You do not have income if your student loan is cancelled because you agreed to certain conditions to obtain the loan and then performed the services required. Under the terms of the loan you must be required to work for a specified period of time in certain professions for one of a broad class of employers. To qualify the loan must have been made by:

1) The government—federal, state, or local or an instrumentality, agency, or subdivision thereof,
2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
3) An educational institution under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan.

Cancellations of student loans under section 465 of the Higher Education Act of 1965 also are not income.

Constructively received income. You are generally taxed on income that is available to you, regardless of whether it is actually in your possession.

If a third party is paid income from property you own, you have constructively received the income. It is the same as if you had received the income and paid it to the third party.

Income received by an agent for you is income you constructively received in the year the agent received it. If you agree by contract that a third party is to receive income for you, you must include the amount in gross income when the third party receives it.

Example 1. You agree with your employer that part of your salary is to be paid directly to your former spouse. You must include that amount in gross income when your former spouse receives it.

Example 2. You assign your "lifetime services" to a trust. By agreement, your employer pays the trust a monthly fee for your services equal to what otherwise would be your gross monthly salary. You continue to do the same work for your employer. You must include in income as wages the amounts your employer pays to the trust.

A valid check you received or that was made available to you before the end of the tax year is considered income constructively received in that year, even if you do not cash the check or deposit it to your account until the next year.

For example, if the postal service tries to deliver a check to you on the last day of the tax year but you are not at home to receive it, you must include the amount in income for that tax year. If the check was mailed so that it could not possibly reach you until after the end of the tax year, and you could not otherwise get the funds before the end of the year, you include the amount in income for the next tax year.

No constructive receipt. There may be facts to show that you did not constructively receive income.

Example 1. Alice Johnson, a teacher, agreed to the school board's condition that, in her absence, she would be entitled to receive only the difference between her regular salary and the salary of a substitute teacher hired by the school board. Therefore, Alice did not constructively receive the amount by which her salary was reduced to pay the substitute teacher.

Example 2. Attorney-faculty members and students of a university law school who are court-appointed representatives of indigent defendants do not include in income amounts received for their services and turned over to the university. The representation must be part of the school's clinical program in its regular teaching curriculum.

Court awards and damages. To determine if settlement amounts you receive by compromise or judgment must be included in income, you must consider the item which the settlement replaces. Include the following as ordinary income:

1) Interest on any award.
2) Compensation for lost wages or lost profits.
3) Punitive damages.
4) Amounts received in settlement of pension rights (if you did not contribute to the plan).
5) Damages for:
   a) Patent or copyright infringement.
   b) Breach of contract.
   c) Interference with business operations.

Do not include as income compensatory damages for the following:

1) Personal injury or sickness (whether received in a lump sum or installments).
2) Damage to your character.
3) Alienation of affection.
4) Surrender of custody of a minor child.

Note. Amounts received as damages for personal injury or sickness are not compensation for lost wages or profits, even when measured by the amount of wages or profits that could have been earned if not for the injury or sickness.

Estate and trust income. An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you are taxed on your share of its income. However, there is never a double tax. Estates and trusts file their returns on Form 1041, *U.S. Fiduciary Income Tax Return,* and report your share of the income on Schedule K–1 of Form 1041.

Current income required to be distributed. If you are the beneficiary of a trust that must distribute currently all of its income, you must report your share of the distributable net income whether or not you actually received it.

Current income not required to be distributed. If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or a part of the current income, you must report all income that is required to be distributed to you, whether or not it is actually distributed, plus all other amounts actually paid or credited to you, to the extent of your share of distributable net income.

How to report estate and trust income. Each item of income keeps the same character in your hands as it had in the hands of the estate or trust. Thus, if items of income distributed or treated as distributed to you include dividends, tax-exempt interest, or capital gains, they will keep the same character in your hands for purposes of reporting those items on your return.

The fiduciary of the estate or trust must tell you the type of items making up your share of the estate or trust income and any credits you are allowed on your individual income tax return.

Losses of estates and trusts generally are not deductible by the beneficiaries.

Grantor trust. Income earned by a grantor trust is taxable to the grantor, not the beneficiary. This rule applies if the property put into the trust will revert (be returned) to the grantor or the grantor's spouse. Generally, for transfers after March 1, 1986, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property. For transfers in trust made before March 2, 1986, a trust was a grantor trust if it was expected that the property would revert to the grantor within 10 years.

Fees. Include all fees for your services in gross income. Examples of these fees are amounts you receive for services you perform as:

1) A corporation director.
2) An executor or administrator of an estate.
3) A notary public.
4) An election precinct official.

If these payments total $600 or more for the year, the payer must report the fees to the IRS on Form 1099–MISC. You will receive a copy of the Form 1099–MISC.

A free tour you receive from a travel agency for organizing a group of tourists must be included in income on line 22, Form 1040, or on Schedule C (Form 1040) at the fair market value of the tour. You cannot deduct your expenses in serving as the voluntary leader of the group at the group's request.

Gambling winnings. You must include your gambling winnings in income on line 22, Form 1040. If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings.

Winnings from lotteries and raffles are gambling winnings. You must include in income bonds, cars, houses, and other noncash prizes at their fair market value.

Note. If you win a state lottery prize payable in installments, you must include in gross income the annual payments and any amount you receive designated as "interest" on the unpaid installments.

Hobby losses. Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See *Activity not for profit*, earlier.

Note. If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain. However, if you sell items from your collection at a loss, you cannot deduct a net loss.

Illegal income, such as stolen or embezzled funds, must be included in gross income on line 22, Form 1040, or on Schedule C (Form 1040).

Indian fishing rights. If you are a member of a qualified Indian tribe that has fishing rights secured by treaty, Executive order, or an Act of Congress as of March 17, 1988, you do not include in income amounts you receive from activities related to those fishing rights. The income is not subject to income tax, self-employment tax, or employment taxes.

Jury duty pay you receive must be included in income. If you are required to give the pay to your employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an adjustment to income. Include the amount you repay your employer on line 30, Form 1040, and write "Jury pay" and the amount on the dotted line next to line 30.

Kickbacks. You must include in income on line 22, Form 1040, or on Schedule C (Form 1040), kickbacks, side commissions, push money, or similar payments you receive.

Example. You are a car salesperson and help arrange car insurance for buyers. Insurance brokers kick back part of their commissions to you for referring customers to them. You must include the kickbacks in income.

Note received for services. If your employer gives you a note as payment for your services, you must include the fair market value (usually the discount value) of the note in income for the year you receive it. When you later receive payments on the note, part of each payment is a recovery of the fair market value that you previously included in income. Do not include that part again in income. Include the rest of the payment in income in the year of payment.

Prepaid income is generally included in gross income in the year you receive it. Prepaid income includes amounts such as rents or interest received in advance and compensation for future services.

However, if you use the accrual method of accounting and receive payment for services to be performed before the end of the next tax year, you can include the payment in gross income as you earn it by performing the services.

Prizes and awards. If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in income. For example, if you win a $50 prize in a photography contest, you must report this income on line 22, Form 1040.

Employee cash awards or bonuses. Cash awards or bonuses given to employees for their good work or for suggestions must be included in income as wages. However, certain employee awards can be excluded from income. See *Employee achievement awards*, later.

Prizes and awards in goods or services must be included in income at their fair market value. If you refuse to accept a prize, do not include it in income.

If you are a salesperson and receive "prize points" redeemable for merchandise, which are awarded by a distributor to employees of dealers, you must include their fair market value in income as wages. The "prize points" are taxable in the year they are paid or made available to you, rather than in the year you redeem them for merchandise.

Pulitzer, Nobel, and other prizes awarded in recognition of past accomplishments—in religious, charitable, scientific, artistic, educational, literary, or civic fields—are not included in income if ***all*** of the following requirements are met:

1) You were selected without any action on your part to enter the contest or proceeding.
2) You are not required to perform substantial future services as a condition to receiving the prize or award.
3) The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization as designated by you. The following conditions apply to the transfer:
   a) You cannot use the prize or award before it is transferred.
   b) You should provide the designation before the prize or award is presented to prevent a disqualifying use. The designation should contain:
      (i) The purpose of the document by making a reference to section 74(b)(3) of the Internal Revenue Code.
      (ii) A description of the prize or award.
      (iii) The name and address of the organization to receive the prize or award.
      (iv) Your name, address, and social security number.
      (v) Your signature and the date signed.
   c) In the case of an unexpected presentation, you must return the prize or award before using it (or spending, depositing, investing it, etc., in the case of money) and then prepare the statement as described in (b).
   d) After the transfer, you should receive from the payer a written response stating when and to whom the designated amounts were transferred.

Sale of personal items. If you sell an item you own for personal use, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, a gain is taxable as a capital gain reported on Schedule D (Form 1040). You cannot deduct a loss.

However, if you sell an item you hold for investment, such as gold or silver bullion, coins, or gems, a gain is taxable as a capital gain and a loss is deductible as a capital loss.

Social security and equivalent railroad retirement benefits. Social security or the social security equivalent part of tier 1 railroad retirement benefits, if taxable, must be included in the income of the person who has the legal right to receive the benefits.

Joint return. If you are married and file a joint return, you and your spouse must combine your incomes and your social security and equivalent railroad retirement benefits when figuring if any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse's income to yours when figuring if any of your benefits are taxable.

Form SSA–1099. If you received social security benefits during 1989, you will receive Form SSA–1099, *Social Security Benefit Statement.* An IRS Notice 703 will be enclosed with your Form SSA–1099. This notice includes a worksheet you can use to figure whether any of your benefits are taxable.

For a full explanation of the information found on your Form SSA–1099, get Publication 915.

Form RRB–1099. If you received equivalent railroad retirement or special guaranty benefits during 1989, you will receive Form RRB–1099, *Statement for Recipients of Payments by the Railroad Retirement Board.* Enclosed with your Form RRB–1099 will be a worksheet you can use to figure whether any of your benefits are taxable. For a full explanation of the information found on your Form RRB–1099, get Publication 915.

If you received other railroad retirement benefits, get Publication 575 for information on how these benefits are taxed.

Lump-sum payment. If you received a lump-sum payment in 1989 for benefits attributable to an earlier year, use the worksheets in Publication 915 to determine the amount, if any, that is taxable.

Taxable amount. Use the worksheet in the Form 1040 instruction package to determine the amount of your benefits to include in income. Publication 915 also has worksheets you can use. However, you ***must*** use the worksheet in Publication 915 if you take the foreign earned income exclusion, the foreign housing exclusion or deduction, the exclusion of income from U.S. possessions, or the exclusion of income from Puerto Rico by bona fide residents of Puerto Rico.

Form 1040. If any of your benefits are taxable, you must use Form 1040 to report the taxable part. You cannot use Form 1040A or Form 1040EZ. Report your net benefits (the amount in Box 5 of your Form 1099) on line 21a, Form 1040. Report the taxable part (from the last line of the worksheet) on line 21b, Form 1040.

Unemployment compensation. You must include in income all unemployment compensation you receive. You may be liable for estimated tax if you receive unemployment compensation. For more information, get Publication 505.

Types of unemployment compensation. Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state. It includes:

1) Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
2) Unemployment insurance benefits.
3) Railroad unemployment compensation benefits.
4) Disability payments from a government program paid as a ***substitute*** for unemployment compensation (amounts received as workers' compensation for injuries or illness are ***not*** unemployment compensation).
5) Trade readjustment allowances under the Trade Act of 1974.
6) Benefits under the Airline Deregulation Act of 1978.

7) Unemployment assistance under the Disaster Relief Act Amendments of 1974.

If you contribute to a governmental unemployment compensation program, and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions.

Supplemental unemployment benefits received from a company-financed fund (and the employees did not contribute to the fund) are not unemployment compensation. They are taxable as wages subject to income tax withholding but not subject to social security or federal unemployment taxes.

You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. However, if you repay the benefits in a later year, you must include the full amount of the benefits in income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income. Include the repayment on line 30, Form 1040, and put "Sub-pay TRA" and the amount on the dotted line next to line 30. If the amount you repay in a later year is more than $3,000, you may be able to take a credit against your tax for the later year instead of deducting the amount repaid. For information on this, see the discussion on *Repayments*, later.

Private unemployment fund. Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on line 22, Form 1040.

Payments by a union. Benefits paid to you as an unemployed member of a union from regular union dues are included in gross income on line 22, Form 1040.

Guaranteed annual wage. Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages.

State employees. Payments may be made by a state to its employees who are not covered by the state's unemployment compensation law. If the payments are similar to benefits under that law, they are fully taxable. Report these payments on line 22, Form 1040.

Fraudulently obtained unemployment compensation is fully taxable and is reported on line 22, Form 1040.

Repayment of unemployment compensation benefits. If you repaid in 1989 unemployment compensation benefits you received in 1989, subtract the amount you repaid from the total amount you received and enter that amount on line 20, Form 1040. Write "Repayment" and the amount you repaid on the dotted line next to line 20. If you repaid in 1989 benefits you included in income in a prior year, see *Repayments*, later.

Union benefits and dues. Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from your salary or wages.

You may be able to deduct some of these payments as a miscellaneous deduction subject to the 2% limit if they are related to your job and if you itemize deductions on Schedule A (Form 1040). For more information, get Publication 529, *Miscellaneous Deductions*.

Strike and lockout benefits paid to you by a union from union dues, including both cash and the fair market value of other property, are usually included in income as wages. You can exclude these benefits from your income only when the facts clearly show that the union intended the benefits as gifts to you.

Reimbursed union convention expenses. If you are a delegate of your union local to the annual convention of the international union, do not include in income amounts you receive from the union to reimburse you for expenses of traveling away from home to attend the convention. You cannot deduct the reimbursed expenses, even if you are reimbursed in a later year. If you are reimbursed for lost salary, you must include that reimbursement in income as wages.

Bartering

Bartering is an exchange of property or services.

Fair market value. You must include in income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Example 1. You are a self-employed attorney who performs legal services for a client, a small corporation. The corporation gives you shares of its stock as payment for your services. You must include the fair market value of the shares in income on Schedule C (Form 1040) in the year you receive them.

Example 2. You are a self-employed accountant. Both you and a housepainter are members of a barter club. The organization each year gives its members a directory of members and the services each member provides. Members get in touch with each other directly and bargain for the value of the services to be performed. In return for accounting services you provided, the housepainter painted your home. You must report as income on Schedule C (Form 1040) the fair market value of the housepainting services you received, and the housepainter must include in income the fair market value of the accounting services you provided.

Example 3. You are a member of a barter club. The club uses "credit units" as a means of exchange. It adds cre[illegible]" units to your account for goods or services you provide to members, which you can use to purchase goods or services offered by other members of the barter club. The club subtracts credit units from your account when you receive goods or services from other members. You must include in income the value of credit units that are added to your account, even though you may not actually receive goods or services from other members until a later tax year.

Example 4. You own an apartment building and an artist gives you a work of art the artist created, in return for 6 months' rent-free use of an apartment. You must report as rental income on Schedule E (Form 1040) the fair market value of the artwork, and the artist must report as income on Schedule C (Form 1040) the fair rental value of the apartment.

Barter exchange. If you exchanged property or services through a barter exchange, you should receive Form 1099–B, *Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions*, or a similar statement from the barter exchange. You should receive the statement by January 31, 1990, and it should show the value of cash, property, services, credits, or scrip you received from exchanges during the year. The IRS will get a copy of Form 1099–B.

Backup withholding. The income you receive from bartering is generally not subject to regular income tax withholding. However, backup withholding will apply in certain circumstances to ensure that income tax is collected on this income.

Under backup withholding, the barter exchange must withhold, as income tax, 20% of the income if:

1) You do not give the barter exchange your identification number (either a social security number or an employer identification number), or
2) The IRS notifies the barter exchange that you gave it an incorrect identification number.

If you join a barter exchange, you must certify under penalties of perjury that your social security or employer identification number is correct and that you are not subject to backup withholding. If you do not make this certification, backup withholding may begin immediately. The barter exchange will give you a Form W–9, *Payer's Request for Taxpayer Identification Number and Certification*, or a similar form, for you to make this certification.

Reporting the tax withheld. If tax is withheld from your barter income, the barter exchange must give you a Form 1099–B, or similar statement, that indicates the amount of tax withheld.

Partnership Income

A partnership is not a taxable entity. The income, gains, losses, credits, and deductions of a partnership are "passed through" to the partners based on each partner's distributive share of these items.

Partner's distributive share. Your distributive share of partnership income, gains, losses, deductions, or credits is your share of these items of the partnership, based on the partnership agreement, whether or not they are actually distributed to you. Generally, your distributive share of the partnership losses is limited to the adjusted basis of your partnership interest at the end of the partnership year in which the losses took place.

The partnership agreement usually covers the distribution of profits, losses, and other items. However, if there is no agreement for sharing a specific item of gain or loss, generally each partner's distributive share is figured according to the partner's interest in the partnership.

Partnership return. Although a partnership pays no tax, it must file an information return on Form 1065, *U.S. Partnership Return of Income*. This shows the result of the partnership's operations for its tax year and the items that must be "passed through" to the partners.

Partner's return. You are required to treat partnership items the same way on your individual return that they are treated on the partnership return. That is, if the partnership had a capital gain, you report your share on Schedule D (Form 1040). You report your share of partnership ordinary income on Schedule E (Form 1040).

Schedule K–1 (Form 1065). You should receive from each partnership in which you are a member, a copy of the *Partner's Instructions for Schedule K–1 (Form 1065)*, together with a copy of Schedule K–1 (Form 1065) showing your share of income, deductions, credits, and tax preference items of the partnership for the tax year. Retain Schedule K–1 (Form 1065) for your records. Do not attach it to your Form 1040.

For more information, get Publication 541, *Tax Information on Partnerships*.

S Corporation Income

In general, an S corporation does not pay tax on its income. Instead, the income and expenses of the corporation are "passed through" to the shareholders.

S corporation return. An S corporation generally does not pay tax, but it must file a return on Form 1120S, *U.S. Income Tax Return for an S Corporation.* This shows the results of the corporation's operations for its tax year and the items of income, gains, losses, deductions, or credits that affect the shareholders' individual income tax returns.

Shareholder's return. If you are a shareholder in an S corporation, you must include on Form 1040 your share of the corporation's income or loss in the same way as the income or loss of a partnership.

All current year income or loss and other tax items are taxed to you at the corporation's year end. Generally, these items passed through to you as a shareholder will increase or decrease the basis of your S corporation stock as appropriate.

Distributions. Generally, S corporation distributions are a nontaxable return of your basis in the corporation stock. However, in certain cases, part of the distributions may be taxable as a dividend, or as a long-term or short-term capital gain, or as both. The corporation's distributions may be in the form of cash or property.

Dividends are paid only from prior year earnings (generally retained earnings from years prior to 1983 or prior to becoming an S corporation). Generally, property (including cash) distributions, except dividend distributions, are considered a return of capital to the extent of your basis in the stock of the corporation. Distributions in excess of basis are treated as a gain from the sale or exchange of property.

Schedule K–1 (Form 1120S). You should receive from the S corporation in which you are a shareholder a copy of the *Shareholder's Instructions for Schedule K–1 (Form 1120S),* together with a copy of Schedule K–1 (Form 1120S) showing your share of income, credits, and deductions of the S corporation for the tax year. Your distributive share of the items of income, gains, losses, deductions, or credits of the S corporation must be shown separately on your Form 1040. The character of these items generally is the same as if you had realized or incurred them personally.

For more information, get Publication 589, *Tax Information on S Corporations.*

Recoveries

A recovery is a return of an amount you deducted or took a credit for in a prior year. Generally, you must include part or all of the recovered amounts in income in the year the recovery is received. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). Non-itemized deduction recoveries include such items as payments you receive on previously deducted bad debts, reimbursements not included on your Form W–2 for an employee business expense deducted before 1987, and recoveries on items for which you previously claimed a tax credit.

If you recover amounts you deducted in a previous year that are attributable to itemized deductions and to non-itemized deductions, recompute your taxable income first as shown in *Non-Itemized Deduction Recoveries* before you determine the amount to include in income as shown in *Itemized Deduction Recoveries.*

Interest on any of the amounts you recover must be reported as interest income in the year received.

Recovery and expense—same year. If the refund or other recovery and the deductible expense occur in the same year, the recovery reduces the deduction and is not reported as income.

Refunds of federal income taxes are not included in income because they are never allowed as a deduction from income.

Recovery attributable to 2 or more years. If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a pro rata basis, the recovered amount between the years in which it was paid.

This allocation is necessary to determine the amount of recovery attributable to any prior years and to determine the amount, if any, of your allowable deduction for this item for the current year.

Example. You paid a 1988 estimated state income tax liability of $4,000 in four equal payments. You made your fourth payment in January 1989. You had no state income tax withheld during 1988. In 1989, you received a $400 tax refund based on your 1988 state income tax return. You claimed itemized deductions each year on your federal income tax return.

You must allocate the $400 refund between 1988 and 1989, the years in which you paid the tax on which the refund is based. Since you paid 75% ($3,000 ÷ $4,000) of the estimated tax in 1988, 75% of the $400 refund, or $300, is for amounts you paid in 1988 and is a recovery item. If all of the $300 is a taxable recovery item, you will include $300 on line 10, Form 1040, for 1989, and attach a copy of your computation showing why the amount on line 10 is less than the amount shown on the Form 1099–G, *Statement for Recipients of Certain Government Payments,* you received from the state.

The balance ($100) of the $400 refund is for your January 1989 estimated tax payment. When you figure your deduction for state and local income taxes paid during 1989, you will reduce the $1,000 paid in January by $100. Your deduction for state and local income taxes paid during 1989 will include the January net amount of $900 ($1,000 − $100), plus any estimated state income taxes paid in 1989 for 1989, any state income tax withheld during 1989, and any tax paid with your state income tax return filed in 1989.

Itemized Deduction Recoveries

If you recover any amount that you deducted in a prior year on Schedule A (Form 1040), you must determine how much, if any, of the recovery to include in your income.

Due to changes in the tax law, different computations are needed for the recovery of items deducted after 1986 or before 1987. The discussions in this section apply to recoveries from any year, unless otherwise noted.

Standard deduction. To determine if amounts deducted in 1988 and recovered in 1989 must be included in income, you must know the standard deduction for your filing status in 1988. The standard deduction table for 1988 is at the end of this publication. For information on the standard deduction, get Publication 501, *Exemptions, Standard Deduction, and Filing Information.*

Before 1987. To determine if amounts deducted before 1987 and recovered in 1989 must be included in income, you must know the amount of your excess itemized deductions and your zero bracket amount for the year the amount was deducted. These amounts can be found on Schedule A (Form 1040) for the year you deducted the amounts recovered in 1989.

Form 1099–G. If you received a state or local income tax refund (or credit or offset) in 1989, you may receive Form 1099–G from the payer of the refund by January 31, 1990. The IRS will receive a copy of Form 1099–G.

No prior year deduction. If you did not itemize deductions in the year for which you received the recovery, you do not include any of the recovery amount in income.

Example. In 1988, you filed your income tax return on Form 1040A. In 1989, you received a refund from your 1988 state income tax. You do not report any of the refund as income because you did not itemize deductions in 1988.

Recovery limited to deduction. You do not include in income any amount of your recovery that exceeds the amount you deducted in the prior year. The amount you include in income is limited to the smaller of:

1) The amount deducted on Schedule A (Form 1040), or
2) The amount recovered.

Example. During 1988, you paid $1,200 for medical expenses. From this amount you subtracted $1,000, which was 7.5% of your adjusted gross income. Your actual medical expense deduction was $200. In 1989, you received a $500 reimbursement from your medical insurance for your 1988 expenses. The only amount of the $500 reimbursement that may be considered income in 1989 is $200—the amount actually deducted.

Worksheets for refunds of itemized deductions. You can use the worksheets at the end of this publication to determine the amount, if any, of your recoveries to include in income. There are two worksheets: one for refunds of amounts deducted ***before 1987*** and one for amounts deducted ***after 1986.*** The worksheets are particularly useful if you do not include your total recoveries in income.

The following discussion explains how to determine the amount of itemized deduction recoveries to include in income. However, you can use the worksheets without this explanation.

Total recoveries included in income. The total amount recovered in 1989 is included in income if certain requirements are met. These requirements are different for amounts deducted after 1986 and amounts deducted before 1987. The recoveries included in income will not be more than the amount deducted. See *Tax Benefit Rule,* later.

- Amounts deducted **after 1986** will be included in income if:
  a) The recoveries are equal to or less than the amount by which your itemized deductions exceeded the standard deduction for your filing status in the prior year, and
  b) Your taxable income in the prior year was –0– or more.
- Amounts deducted **before 1987** will be included in income if:
  a) The recoveries are equal to or less than the prior year's excess itemized deductions, and
  b) Your taxable income in the prior year was not less than your zero bracket amount.

Enter your state and local income tax refund on line 10, Form 1040, and the total of all other recoveries as other income on line 22, Form 1040.

Example. In 1988, your taxable income was $20,000, the standard deduction for your filing status was $5,000, and you had itemized deductions of $7,000. In 1989, you received the following recoveries for amounts deducted in 1988:

Medical expenses	$200
State and local income tax refund	400
Real estate tax rebate	300
Interest expense	25
Total recoveries	$925

Because your total recoveries are less than the amount your itemized deductions exceeded the standard deduction ($7,000 − 5,000 = $2,000), and your 1988 taxable income was $20,000, you must include your total recoveries in income in 1989. Report the state and local income tax refund of $400 on line 10, Form 1040, and the balance of your recoveries, $525, on line 22, Form 1040.

Total recoveries not included in income. The total recovery that must be included in income is limited to the itemized deductions amount that reduced your tax in the prior year. (See *Tax Benefit Rule*, later.)

After 1986 you are generally allowed to claim the standard deduction if you do not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule. Therefore, include in income the smaller of:

1) Your recoveries, or
2) The amount by which your itemized deductions exceeded the standard deduction.

Example. You filed a joint return in 1988. Your itemized deductions were $7,000. The standard deduction that you could have claimed was $5,000. In 1989 you recover $2,400 of your 1988 itemized deductions. You include $2,000 of the recovery in your 1989 income. This is the smaller of your recoveries ($2,400) or the amount by which your itemized deductions exceeded the standard deduction ($7,000 − 5,000 = $2,000).

Before 1987. Because only excess itemized deductions before 1987 could reduce tax, the recovered amount of these deductions required to be included in income in 1989 is not more than the excess of your itemized deductions over your zero bracket amount (excess itemized deductions).

The zero bracket amount was not taxed. Therefore, if your taxable income was zero or more, but less than your zero bracket amount, only part of your excess itemized deductions reduced the tax. To figure that part, reduce the excess itemized deductions by the difference between your zero bracket amount and your taxable income. You are not required to include the recovery in income to the extent that it is more than the reduced excess itemized deductions.

Negative taxable income. After 1986, if your taxable income was a negative amount, reduce the recovery you must include in income by the negative amount.

Example. In the previous example assume you had a negative taxable income of $200 in 1988. You would include $1,800 in your 1989 income, rather than $2,000.

Before 1987. If your taxable income was a negative amount, only part of your excess itemized deductions reduced the tax. To figure that part, add your taxable income to your zero bracket amount and subtract this total from your excess itemized deductions. The difference is the part that reduced your tax in the prior year. The recovery you are required to include in income is not more than the difference.

Allocation of recoveries to be included. If you are not required to include all of your recoveries in income, and you have both a state income tax refund and other itemized deduction recoveries, you must allocate part of the taxable recoveries to report as a state tax refund on line 10, Form 1040. The balance of your taxable recoveries is reported as other income on line 22, Form 1040. You can use the worksheets at the end of this publication to figure the part to report as a state tax refund, or you can figure that part as follows:

1) Divide your state income tax refund by the total of all your itemized deduction recoveries. The result is the percentage that the state income tax refund represents of the total recoveries.
2) Multiply the amount of taxable recoveries by the percentage.

Example. Assume you recovered in 1989 $2,500 of your 1988 itemized deductions, but that the recoveries you must include in your 1989 income are only $1,500. Of the $2,500 you recovered, $500 was due to your state income tax refund. The amount you report as a tax refund on line 10, Form 1040, is $300 ($500 ÷ $2,500 = 20% × $1,500). The balance of the taxable recoveries, $1,200, is reported as other income on line 22, Form 1040.

Taxpayers required to itemize. If you were required to itemize deductions in a prior year, all of your recoveries, up to the amount deducted, must be included in income.

Non-Itemized Deduction Recoveries

This section discusses recovery of deductions other than those deducted on Schedule A (Form 1040). Recovery of tax credits is discussed later.

Total recoveries included in income. Recovery of amounts deducted in a prior year must be included in income in the year received to the extent the deduction reduced your tax in the year of the deduction. (See *Tax Benefit Rule*, later.)

Total recoveries not included in income. After 1986, if your taxable income is a negative amount, reduce the recovery by that negative amount. Include this reduced recovery in income.

Before 1987. If your taxable income for the year of the deduction was less than your zero bracket amount, reduce the amount of your recoveries by the difference between your zero bracket amount and your taxable income. The reduced recovery must be included in income because it equals the deduction that reduced your tax.

Example. In 1989, you recovered $2,000 of an employee business expense deducted in 1986 as an adjustment to income. Your employer did not include the $2,000 on your Form W–2. In 1986, your zero bracket amount was $3,400 and your taxable income was $3,000. You compute the amount of your recovery to include in income as follows:

Total recovery		$2,000
Zero bracket amount	$3,400	
Less: Taxable income	3,000	400
Recovery to include in income		$1,600

Itemized and non-itemized deduction recoveries. If you recover amounts due to both itemized deductions and non-itemized deductions taken in the same year, you must determine the amounts to include in income as follows:

1) Figure your non-itemized recoveries,
2) Add the non-itemized recoveries to your taxable income, and then
3) Figure your itemized recoveries.

This order is required because your taxable income will change and you must use taxable income to figure your itemized recoveries.

Example. Assume the same facts as the previous example. In addition to the employee business expense recovery, you also recovered a state income tax refund of $1,000 and a property tax rebate of $200. Your excess itemized deductions in 1986 were $2,500. Before you figure the amount of itemized deduction recoveries to include in income, you must adjust your 1986 taxable income by the amount of non-itemized deduction recoveries to include in your 1989 income as follows:

Taxable income per 1986 return	$3,000
Non-itemized deduction recovery	1,600
Adjusted 1986 taxable income	$4,600

Since your taxable income as adjusted for 1986 exceeds your zero bracket amount, and your excess itemized deductions exceeded your itemized deduction recoveries, the entire amount of your itemized deduction recoveries must be included in income. Report the state income tax refund of $1,000 on line 10, Form 1040. The remainder of your recoveries, $1,800 ($1,600 + $200), is reported on line 22, Form 1040.

Amounts Recovered for Credits

If you received a recovery in 1989 for an item on which you claimed a tax credit in a prior year, you must increase your 1989 tax to the extent the credit reduced your tax in the prior year. You have a recovery if there is a downward price adjustment or similar adjustment on the item for which you claimed a credit.

This rule does not apply to the investment credit or the foreign tax credit. Recoveries with respect to these credits are covered by other provisions of the law.

Tax Benefit Rule

If you recover an amount that you deducted or took a credit for in a prior year, include the recovery in income only to the extent the deduction or credit reduced your tax in the prior year. Generally, you can figure the deduction amount that reduced your tax in the prior year by using the methods discussed earlier. These methods are for the most common situations and are comparatively simple because you are not required to recompute the prior year's tax.

Special situations. If a deduction reduced your taxable income, but did not reduce your tax because you either were subject to the alternative minimum tax or had tax credits that reduced your tax to zero, you will need to recompute the prior year's tax to determine whether you can exclude the recovery amount from income.

Tax credits—prior year. If you recover an item deducted in a prior year in which your tax credits exceeded your tax, you must refigure the prior year's tax to determine if you must include the recovery in income. To do this, add the amount of the recovery to your prior year's taxable income and figure the tax on the recomputed amount. If your tax credits exceed the recomputed tax, you did not have a tax benefit from the deduction. Do not include the recovery in income. If the tax credits are less than the recomputed tax, include the recovery in income to the extent it reduced your tax in the prior year.

Example. In 1988, Jean Black filed as head of household and itemized her deductions. Her taxable income was $5,260 and her tax was $791. She claimed a child care credit of $1,200. The credit reduced her tax to zero and she had an unused tax credit of $409 ($1,200 minus $791). In 1989, Jean recovered $1,000 of her itemized deductions. She adds $1,000 to her 1988 taxable income and recomputes that year's tax, but the child care credit exceeds the recomputed tax of $941, as shown in the following table:

	1988 Taxable Income	Tax	Tax Credit	Net Tax
As Filed	$5,260	791	1,200	0
Recovery	1,000			
Recomputed	$6,260	941	1,200	0

Jean's tax liability for 1988 has not changed by including the recovery in income for that year. Therefore, she did not have a tax benefit from the recovered deduction and does not include any of the recovery in income for 1989. If, however, the recomputed tax had been more than her tax credit, she would have to include the recovery in her 1989 income to the extent it reduced her tax in 1988.

Alternative minimum tax—prior year. If you were subject to the alternative minimum tax in the year of the deduction, you will have to recompute your tax for the prior year to determine if the recovery must be included in income. This will require a recomputation of your regular tax, as shown in the example for tax credits, and a recomputation of your alternative minimum tax. If inclusion of the recovery does not change your total tax, you do not include the recovery in income. However, if your total tax increases (by any amount), you did have a tax benefit from the

deduction and you must include the recovery in income to the extent the deduction reduced your tax in the prior year.

Repayments

If you had to repay, during your tax year, an amount that you had included in income in an earlier year because at that time you thought you had an unrestricted right to it, you can deduct the amount repaid from your income for this year.

Type of deduction. The type of deduction in the year of repayment depends on the type of income you included in the earlier year. For instance, if you repay an amount that you previously reported as a capital gain, deduct the repayment as a capital loss. If you repay advance commissions and other earnings, see the following discussion pertaining to the amount repaid.

If you repaid social security or the equivalent railroad retirement benefits, get Publication 915. If you repaid other railroad retirement benefits, get Publication 575.

Repayment—$3,000 or less. If the amount you repaid was $3,000 or less, deduct it from income on the same form or schedule on which you previously reported it. For example, if you reported it as a capital gain, deduct it on Schedule D (Form 1040). If you reported it as wages, or other ordinary income, deduct it on line 21, Schedule A (Form 1040).

Repayment—over $3,000. If the amount you repaid was more than $3,000, you can take a deduction for the amount repaid, or you can take a credit against your tax. Follow the steps below and compare the results. Use the method (credit or deduction) that results in less tax.

1) Figure your tax for 1989 claiming a deduction for the repaid amount.
2) Figure your tax for 1989 ***without*** deducting the amount you repaid. Then,
   a) Refigure your tax from the earlier year without including the amount you repaid in 1989.
   b) Subtract the tax in (a) from the tax shown on your return for the earlier year.
   c) Then subtract the answer in (b) from the tax for 1989 figured without the deduction.

How you treat the repayment on your 1989 return depends on which answer above results in less tax.

- If the answer in (1) is less tax, deduct the amount repaid on the same form or schedule on which you previously reported it. Generally, this is line 25 of Schedule A (Form 1040).
- If the answer in (2) is less tax, claim a credit on line 62, Form 1040, and write "I.R.C. 1341" in the margin to the left of line 62.

Example. In 1987 you filed a joint return and reported your income on the cash method. In 1989 you repaid $5,000 included in your 1987 gross income under a claim of right. Your filing status in 1989 is the same as 1987. Your income and tax for both years are as follows:

	1987 (With Income)	1987 (Without Income)
Taxable Income	$55,200	$50,200
Tax Liability	12,410	10,660

	1989 (Without Deduction)	1989 (With Deduction)
Taxable Income	$47,670	$42,670
Tax Liability	9,326	7,926

Your tax under method (1) is $7,926. Your tax under method (2) is $7,576, figured as follows:

Tax previously determined for 1987	$ 12,410
Less: Tax as refigured	10,660
Decrease in 1987 tax	$ 1,750
Regular tax liability for 1989	$ 9,326
Less: Decrease in 1987 tax	1,750
Refigured tax for 1989	$ 7,576

You pay less tax under method (2), and therefore, you must take a credit for the decrease in 1987 tax. Enter $1,750 on line 62, Form 1040, and put "I.R.C. 1341" in the left margin.

If, by using method (2), your credit is more than your tax, the excess will be refunded to you or applied to your account.

Net operating loss. Special rules apply if you have a net operating loss because of deducting or excluding the amount repaid. Get Publication 536, *Net Operating Losses.*

Repayment does not apply. This discussion does not apply to:

1) Deductions for bad debts.
2) Deductions from sales to customers, such as returns and allowances, and similar items.

Year payment deducted. If you use the cash method, you can take the deduction for the tax year in which you actually make the repayment. If you use any other accounting method, you can deduct the repayment only for the tax year in which it is a proper deduction under your accounting method. For example, if you use the accrual method, you are entitled to the deduction in the tax year in which the obligation for the repayment accrues.

Royalties

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.

You generally report royalties on Part I, Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report gross income and expenses on Schedule C (Form 1040).

Copyrights and patents. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

You can recover your cost or other basis through depreciation deductions over the life of the copyright or patent. Get Publication 534, *Depreciation.*

Oil, gas, and minerals. Royalty income from oil, gas, and mineral properties is the amount you receive upon the extraction of natural resources from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, get Publication 535.

Coal and iron ore. Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income. For information about gain or loss from the sale of coal and iron ore, get Publication 544, *Sales and Other Dispositions of Assets.*

Interest in the property sold. If you sell your complete interest in the oil, gas, or mineral rights, the amount you receive is considered payment for the sale of your property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040).

Also, you can report the sale as an installment sale if you are to receive at least one payment after the tax year in which the sale took place. Get Publication 537.

Part of future production sold. If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

Your payments for the buyer's share of the proceeds are treated as a loan repayment. The buyer will treat the share as a return of capital that is not included in income or subject to a depletion allowance. Any interest factor received by the buyer will be treated as ordinary income not subject to the allowance for depletion.

If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment is ordinary income subject to a depletion allowance.

Income Not Taxed

The following income items are totally or partly excluded from taxable income. Each has been discussed in this publication or is discussed in another publication. Following the list, other totally or partly excluded items are discussed.

Accident and health insurance proceeds
"Black lung" benefits
Casualty insurance and other reimbursements (get Publication 547)
Child support payments (get Publication 504)
Federal Employees' Compensation Act payments
Government cost-of-living allowances
Interest on state or local obligations (get Publication 550)
Meals and lodging
Members of the clergy housing allowance
Military allowances (get Publication 3)
Scholarships and fellowship grants (get Publication 520)
Social security benefits and equivalent railroad retirement benefits
Veterans' benefits
Workers' compensation

Campaign contributions are not income to a candidate unless they are diverted to his or her personal use. To be exempt from tax, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains realized on sales of contributed securities are taxable and must be reported on Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations.* Excess campaign funds transferred to an office account must be included in the officeholder's income on line 22, Form 1040, in the year transferred.

Car pools. You cannot deduct the costs of repairs, gas, and similar items in driving a car in a car pool to and from work. Do not include

amounts you receive from the passengers in income. These amounts are considered reimbursement for your expenses. However, this rule does not apply if you have developed car pool arrangements into a profit-making business of transporting workers for hire.

Cash rebate on purchase of car or other item. A cash rebate you receive from a dealer or manufacturer of an item you buy is not income.

Example. You buy a new car for $9,000 cash and receive a $400 rebate check from the manufacturer. The $400 is not income to you. Your cost is $8,600. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business.

Employee achievement awards. You can exclude from income employee achievement awards you receive only if your employer can deduct them. To be deducted by your employer, and excluded by you, the award must meet all the following requirements:

1) Be given for length of service or safety achievement.
2) Be tangible personal property.
3) Be given under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.
4) Be given as part of a meaningful presentation.
5) Be no more than the specified dollar limits.

Dollar limits. There are limits to the total awards you can exclude in one year. Awards from non-qualified plans are limited to $400, and total awards, from both qualified and non-qualified plans, are limited to $1,600. The cost to your employer is the determining factor for these limits. Amounts over the limits cannot be deducted by your employer and must be included in your income.

A qualified plan award is one you are awarded as part of an established written plan by your employer that does not discriminate in favor of highly compensated employees. An award will not be considered a qualified plan award if the average cost of all employee achievement awards given by your employer during the tax year is more than $400. In determining average cost, awards of nominal value are not taken into account.

Example. Ben Green received three employee achievement awards during 1989: a non-qualified plan award of a watch valued at $250, and two qualified plan awards of a stereo valued at $1,000 and a set of golf clubs valued at $500. Assuming that the requirements for qualified plan awards are otherwise satisfied, each award by itself would be excluded from income. However, since the total value of the awards is more than $1,600, Ben must include the excess of $150 ($1,750 – $1,600) in income.

Food program payments to day care service. If you operate a day care service and receive payments under the Child Care Food Program administered by the Department of Agriculture, do not include the payments in gross income to the extent you use them to provide food to children eligible for help under the program.

Foster-care providers. Payments you receive from a state, political subdivision, or tax-exempt child placement agency for providing foster care to qualified individuals in your home are not included in income. You cannot deduct the related expenses. However, you must include in income payments received for the care of more than 5 individuals age 19 and older.

A qualified foster individual is a person who:

1) Is living in a foster family home, and
2) Was placed there by:
   a) An agency of a state or one of its political subdivisions, or
   b) A tax-exempt child placement agency licensed by a state (if the individual is under age 19).

Difficulty-of-care payments are not included in income. These are additional payments made to foster-care providers of physically, mentally, or emotionally handicapped individuals by a state, political subdivision, or tax-exempt child placement agency that are designated as difficulty-of-care payments. A state must determine the additional compensation is needed. You must include in income difficulty-of-care payments received for more than:

1) 10 children under age 19, and
2) 5 individuals age 19 and older.

Maintaining space in home. If you are paid by a placement agency to maintain space in your home for foster-care individuals, or if you receive payments that you must include in income, you are in business as a foster-care provider and you are self-employed. You must include these payments in income. You can deduct expenses related to these payments. Report the income and expenses on Schedule C and net business income on Schedule SE (Form 1040).

Get Publication 587, *Business Use of Your Home*. For more information on foster care, get Publication 501.

Gifts and inheritances. Property you receive as a gift, bequest, or inheritance is not included in income. However, if property you receive this way later produces income such as interest, dividends, or rentals, that income is taxable to you. If property is given to a trust and the income from it is paid, credited, or distributed to you, that also is income to you. If the gift, bequest, or inheritance is the income from the property, that income is taxable to you.

Items given to you as an incentive to enter into a business transaction are not gifts. For example, items such as small appliances or dinnerware given to you by a bank as an incentive to make a deposit are interest income to you and must be reported at their fair market value.

If you sell an interest in an expected inheritance from a living person, include the entire amount you receive in gross income on line 22, Form 1040.

Bequest for services. A bequest of cash or other property you receive for services you performed while the decedent was alive is taxable compensation.

Historic preservation grants. Do not include in income any payment you receive under the National Historic Preservation Act to preserve an historically significant property.

Interest on frozen deposits. In general, you can exclude from income the amount of interest earned on a frozen deposit. A deposit is frozen if at the end of the calendar year you cannot withdraw any part of the deposit because:

1) The financial institution is bankrupt or insolvent, or
2) The state where the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

The amount of interest you can exclude from gross income for the year is the interest that was credited on the frozen deposit for that tax year minus the sum of:

1) The net amount withdrawn from the deposit during that year, and
2) The amount that could have been withdrawn at the end of that tax year (not reduced by any penalty for premature withdrawals of a time deposit).

The excluded part of the interest is included in gross income the tax year it becomes withdrawable.

Example. For tax year 1989, Bill and Joan Smith had interest income of $1,500 credited to their account. The account is with a bank that has been insolvent since 1985. The Smiths were not able to withdraw any money from this frozen account. They can exclude the $1,500 of interest credited to this account from their 1989 gross income.

Interest on qualified savings bonds. Beginning in 1990, you can exclude from income the interest from qualified U.S. savings bonds you redeem to pay qualified higher education expenses. "Qualified expenses" are for tuition and required fees at an eligible educational institution for you, your spouse, or your dependent. A "qualified U.S. savings bond" is a Series EE savings bond issued after December 31, 1989, to an individual 24 years of age or older. For more information on this exclusion, get Publication 550.

Interest on state and local government obligations is usually exempt from federal tax. For more information, get Publication 550.

Living expenses paid by insurance. Do not include in income amounts you receive under an insurance policy for additional living expenses you and your family had because you lost the use of your home by fire, storm, or other casualty. The amount you exclude from income is limited to your extra living expenses that are more than the normal expenses you would have had. Extra living expenses, for this purpose, include only those to keep you and your family at the same standard of living you had before the loss.

Sale of home. If you are 55 or older and sell your main home, you can choose to exclude from income, under certain conditions, all or part of any gain from the sale. Get Publication 523, *Tax Information on Selling Your Home*.

Qualified scholarships. Only a candidate for a degree can exclude amounts received as a qualified scholarship. A qualified scholarship is any amount you receive that is for:

- Tuition and fees to enroll at or attend an educational organization.
- Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board do not qualify.

All payments you receive for services must be included in income, even if the services are a condition of receiving the grant and are required of all candidates for the degree. This includes amounts received for teaching and research. For more information on scholarships, get Publication 520, *Scholarships and Fellowships*.

Tax-exempt interest. Even though it is not taxable, you must report all tax-exempt interest you receive on Form 1040EZ, 1040A, or 1040.

Transporting schoolchildren. Do not include in income a school board mileage allowance for taking children to and from school if you are not in the business of taking children to school. You cannot deduct expenses of providing this transportation.

Life Insurance Proceeds

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract.

Proceeds not received in installments. If death benefits are paid to you in a lump sum or other than at regular intervals, include them in your gross income only to the extent they are more than the amount payable to you at the time of the

insured person's death. If the benefit payable at death is not specified, you include the benefit payments in income to the extent they are more than the present value of the payments at the time of death.

Proceeds received in installments. If you receive life insurance proceeds in installments, you can exclude part of each installment from income.

To determine the excluded part, divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in income as interest.

Specified number of installments. If you are entitled to receive a specified number of installments under the insurance contract, you figure the excluded part of each installment by dividing the amount held by the insurance company by the number of installments to which you are entitled. A secondary beneficiary, in case you die before you receive all of the installments, is entitled to the same exclusion.

Example. The face amount of the policy is $75,000, and as beneficiary, you choose to receive 120 monthly installments of $1,000 each. The excluded part of each installment is $625 a month ($75,000 ÷ 120), or $7,500 for an entire year. The rest of each payment, $375 a month (or $4,500 for an entire year), is interest income to you.

Specified amount payable. If each installment you receive under the insurance contract is a specific amount, you figure the excluded part of each installment by dividing the amount held by the insurance company by the number of installments necessary to use up the principal and guaranteed interest in the contract.

Example. As beneficiary, you choose to receive $40,000 of proceeds in 10 annual installments of $4,000 plus $400 of guaranteed interest each year. During the year you receive $4,400. You can exclude from gross income $4,000 ($40,000 ÷ 10) as a return of principal. The rest of the installment, $400, is taxable as interest income. (However, see *Surviving spouse*, discussed later.)

Installments for life. If, as the beneficiary under an insurance contract, you are entitled to receive the proceeds in installments for the rest of your life without a refund or period-certain guarantee, you figure the excluded part of each installment by dividing the amount held by the insurance company by your life expectancy. If there is a refund or period-certain guarantee, the amount held by the insurance company for this purpose is reduced by the actuarial value of the guarantee.

Surviving spouse. If your spouse died before October 23, 1986, and insurance proceeds are payable to you because of the death of your spouse, and you receive them in installments, you can exclude up to $1,000 a year of the interest included in the installments. This is in addition to the part of each installment that is excluded as a recovery of the lump sum payable at death. If you remarry, you can continue to take the exclusion.

If your spouse died after October 22, 1986, you cannot exclude any interest payments included in the installment payments.

Interest option on insurance. If an insurance company pays you only interest on proceeds from life insurance left on deposit with them, the interest you are paid is taxable.

If your spouse died before October 23, 1986, and you chose to receive only the interest from your insurance proceeds, the $1,000 interest exclusion for a surviving spouse does not apply. If you later decide to receive the proceeds from the policy in installments, you can take the interest exclusion from the time you begin to receive the installments.

Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. Add any amounts that you previously received under the contract and excluded from income to the lump-sum payment to find how much of the total is a return of your cost and how much is an excess over your cost. Include any excess over your cost in income.

Endowment proceeds that you choose to receive in installments instead of a lump-sum payment at the maturity of the policy are taxed as an annuity. This is explained in Publication 575. For this treatment to apply, you must choose to receive the proceeds in installments before receiving any part of the lump sum, and within 60 days after the lump sum may first be paid to you.

Payments to beneficiaries of deceased employees (death benefit exclusion). The first $5,000 of payments made by or for an employer because of an employee's death can be excluded from the income of the beneficiaries. The payments need not be made as the result of a contract. The amount excluded for any deceased employee cannot be more than $5,000 regardless of the number of employers or the number of beneficiaries.

This exclusion also covers payments of the balance to the credit of a deceased employee under a stock bonus, pension, or profit-sharing plan, as long as they are received during one tax year of the beneficiary.

Example. William Smith was an officer of a corporation at the time of his death last year. The board of directors voted to pay Mr. Smith's salary to his widow for the remainder of the year for his past services. During the year the corporation made payments of $18,000 to the widow. She can exclude from her income the first $5,000 she received, but must include the remaining $13,000 on line 22, Form 1040.

Self-employed individuals. The death benefit exclusion also applies to lump-sum distributions paid on behalf of self-employed individuals, if paid under a qualified pension, profit-sharing, or stock bonus plan.

Payments not qualifying. Any amount that the deceased employee (or self-employed individual) had a guaranteed right to receive, had death not occurred, cannot be excluded as a tax-free death benefit. If the deceased employee was receiving a retirement annuity, and the beneficiary continues to receive payments under a joint and survivor annuity option, these payments do not qualify for the death benefit exclusion. However, if the deceased employee had retired on disability and at the time of death had not reached minimum retirement age, payments to the beneficiary may qualify for the death benefit exclusion. Minimum retirement age generally is the age at which an individual can receive a pension or annuity whether or not that individual is disabled.

Death benefits paid in installments over a period of years are annuity payments. If you are the beneficiary of an employee who died while still employed, the pension or annuity you receive may qualify for the death benefit exclusion. This exclusion is limited to $5,000 and generally applies to the amount by which the present value of the annuity, figured as of the date of the employee's death, is more than the larger of:

1) The employee's contributions to the plan, or
2) The amount the employee had a guaranteed right to receive.

If you are eligible for the exclusion, add it to the cost or unrecovered cost of the annuity in figuring, at the annuity starting date, the investment in the contract. Figure the amount of each payment to exclude from income in the same way as an annuity. Get Publication 575 for more information.

Plan treated as life insurance. Death benefits paid to employees' beneficiaries under certain plans involving risk shifting and risk distribution may qualify as life insurance proceeds. These benefits are not taxable unless the policy was turned over to you for a price. They are not subject to the $5,000 exclusion limit.

Lump-sum payments you receive as the surviving spouse or beneficiary of a person who died may be accrued salary payments; distributions from employee profit-sharing, pension, annuity, and stock bonus plans; or other items that should be treated separately for tax purposes. The tax treatment of these lump-sum payments depends on the type of payment.

Salary or wages received after the death of the employee are usually ordinary income to you.

Lump-sum distributions from qualified employee retirement plans are subject to special tax treatment. For information on these distributions, get Publication 575.

Deceased public safety officers. If you are a surviving dependent of a public safety officer (law enforcement officer or firefighter) who died from injuries received in the line of duty, do not include in income the $50,000 death benefit payable to you. This applies to payments made by the Bureau of Justice Assistance.

Welfare and Other Public Assistance Benefits

Do not include in income benefit payments from a public welfare fund, such as payments due to blindness. Payments from a state fund for the victims of crime should not be included in the victims' incomes if they are in the nature of welfare payments. Do not deduct medical expenses that are reimbursed by such a fund. However, include in income welfare payments obtained fraudulently.

Payments for age and residency. If a state makes payments to its citizens who meet certain age and residency tests, and the payments are not based on need, the payments are not welfare benefits. Include them in gross income on line 22, Form 1040.

Work-training program. Payments you receive from a state welfare agency for taking part in a work-training program are not included in gross income (except for extra allowances for transportation, etc.), as long as the payments do not total more than the public welfare benefits you would have received otherwise. However, if the amount you receive (minus the extra allowances) is more than the welfare benefits you would have received, the entire amount must be included in income as wages.

Handicapped persons employed in community service activities under the Employment Opportunities for Handicapped Individuals Act do not include in income the wages, allowances, or reimbursements paid to them under the Act. Excludable reimbursements include payments for transportation and attendant care, such as interpreter services for the deaf, reader services for the blind, and services to help mentally retarded persons to do their work.

Grants under the Disaster Relief Act of 1974 to help victims of natural disasters are not included in income. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. Disaster unemployment assistance payments under the Act are unemployment benefits that are taxable. See *Unemployment compensation*, earlier.

Mortgage assistance payments under section 235 of the National Housing Act are not included in the homeowner's gross income. Interest paid

for the homeowner under the mortgage assistance program cannot be deducted.

Payments to reduce cost of winter energy. Payments made by a state to qualified people to reduce their cost of winter energy use are not taxable.

Nutrition Program for the Elderly. Food benefits you receive under the Nutrition Program for the Elderly are not taxable. If you prepare and serve free meals for the program, include in income as wages the cash pay you receive, even if you are also eligible for food benefits.

1988 Standard Deduction

Check correct boxes for yourself:
☐ **65 or older** ☐ **Blind**
Check correct boxes for your spouse if you are claiming your spouse's exemption:
☐ **65 or older** ☐ **Blind**
Total number of boxes checked (if none, enter zero) .....

Table I — For Individuals Other Than Dependents

If your filing status was:	and number of boxes you checked was:	your 1988 standard deduction was:
Single	0	$3,000
	1	3,750
	2	4,500
Married filing jointly	0	$5,000
	1	5,600
	2	6,200
	3	6,800
	4	7,400
Married filing separately	0	$2,500*
	1	3,100*
	2	3,700*
	3	4,300*
	4	4,900*
Head of household	0	$4,400
	1	5,150
	2	5,900
Qualifying widow(er)	0	$5,000
	1	5,600
	2	6,200

* If your spouse itemized deductions on a separate return, your standard deduction was zero.

Table II— For Dependents Who Have Earned Income of $500 or Less

If your filing status was:	*and number of boxes you checked was:*	*your 1988 standard deduction was:*
Single	0	$ 500
	1	1,250
	2	2,000
Married filing separately	0	500*
	1	1,100*
	2	1,700*

* If your spouse itemized deductions on a separate return, your standard deduction was zero.

Worksheet For Dependents Who Have Earned Income of More Than $500

A. Enter your earned income for 1988 .....
B. Enter correct amount from following table .....

If your filing status was:	*and number of boxes you checked was:*	*enter on line B:*
Single	0	$ -0-
	1	750
	2	1,500
Married filing separately	0	-0-
	1	600
	2	1,200

C. Add lines **A** and **B** and enter total .....
D. Enter correct amount from following table .....

If your filing status was:	*and number of boxes you checked was:*	*enter on line D:*
Single	0	$3,000
	1	3,750
	2	4,500
Married filing separately	0	2,500*
	1	3,100*
	2	3,700*

E. Compare Lines **C** and **D** and enter the smaller amount. This was your standard deduction for 1988 .....

* If your spouse itemized deductions on a separate return, enter zero on line D.

1987 Standard Deduction

Check correct boxes for yourself:
☐ **65 or older** ☐ **Blind**
Check correct boxes for your spouse if you are claiming your spouse's exemption:
☐ **65 or older** ☐ **Blind**
Total number of boxes checked (if none, enter zero) .....

Table I — For Individuals Other Than Dependents

If your filing status was:	and number of boxes you checked was:	your 1987 standard deduction was:
Single	0	$2,540
	1	3,750
	2	4,500
Married filing jointly	0	$3,760
	1	5,600
	2	6,200
	3	6,800
	4	7,400
Married filing separately	0	$1,880*
	1	3,100*
	2	3,700*
	3	4,300*
	4	4,900*
Head of household	0	$2,540
	1	5,150
	2	5,900
Qualifying widow(er)	0	$3,760
	1	5,600
	2	6,200

* If your spouse itemized deductions on a separate return, your standard deduction was zero.

Table II— For Dependents Who Have Earned Income of $500 or Less

If your filing status was:	and number of boxes you checked was:	your 1987 standard deduction was:
Single	0	$ 500
	1	1,250
	2	2,000
Married filing separately	0	500*
	1	1,100*
	2	1,700*

* If your spouse itemized deductions on a separate return, your standard deduction was zero.

Worksheet For Dependents Who Have Earned Income of More Than $500

A. Enter your earned income for 1987 .....
B. Enter correct amount from following table .....

If your filing status was:	and number of boxes you checked was:	enter on line B:
Single	0	$ -0-
	1	750
	2	1,500
Married filing separately	0	-0-
	1	600
	2	1,200

C. Add lines **A** and **B** and enter total .....
D. Enter correct amount from following table .....

If your filing status was:	and number of boxes you checked was:	enter on line D:
Single	0	$2,540
	1	3,750
	2	4,500
Married filing separately	0	1,880*
	1	3,100*
	2	3,700*

E. Compare Lines **C,** and **D** and enter the smaller amount. This was your standard deduction for 1987 .....

* If your spouse itemized deductions on a separate return, enter zero on line D.

Worksheet for Refunds of Itemized Deductions Amounts Deducted After 1986

If you received refunds, rebates, or reimbursements for any expense you deducted on Schedule A (Form 1040) after 1986, complete this worksheet to figure the amount to include in income on your 1989 Form 1040. If you recovered amounts from more than one year, such as a state income tax refund from 1988 and a casualty loss reimbursement from 1987, complete a separate worksheet for each year. If you also recovered amounts from a year before 1987, you must use both worksheets in this publication. Use information from Schedule A (Form 1040) for the year the expense was deducted.

The amount you may have to include in income is limited to the lesser of the amount deducted for an expense or the amount recovered for that expense. For example, the recovery amount included in income for medical expenses cannot be more than the amount shown on line 4, Schedule A (Form 1040) for 1988, or the amount of the medical expense recovery, whichever is less.

A recovery is included in income only to the extent of the deduction amount that reduced your tax in the prior year (year of the deduction). If you were subject to the alternative minimum tax or your tax credits reduced your tax to zero, see *Tax Benefit Rule*, under *Recoveries*, earlier in this publication.

1. State/local income tax refund or credit.[1] 1) _____
2. Total all other Schedule A refunds or reimbursements.[1] 2) _____
3. Add lines 1 and 2. 3) _____
4. Itemized deductions (line 26, Sch. A for 1988). 4) _____
5. Standard deduction (See worksheets). 5) _____
6. Subtract line 5 from line 4. If the result is zero or less, stop here. The amounts on line 1 and 2 are not taxable. 6) _____
7. Enter the smaller of line 3 or line 6. 7) _____
8. Taxable income for prior year[2] (line 37, Form 1040 for 1988). 8) _____
9. Enter the following amount to include in income— 9) _____

   If line 8 is:

   -0- or more, enter the amount from line 7.

   A negative amount, add lines 7 and 8 and enter net amount (but not less than zero).[3]

Where To Include In Income For 1989

If line 9 equals line 3—

Enter the amount from line 1 on line 10, Form 1040.

Enter the amount from line 2 on line 22, Form 1040.

If line 9 is less than line 3, and either line 1 or line 2 is zero—

If there is an amount on line 1, enter the amount from line 9 as your state/local income tax refund on line 10, Form 1040.

If there is an amount on line 2, enter the amount from line 9 as other income on line 22, Form 1040.

If line 9 is less than line 3, and there are amounts on both lines 1 and 2, complete this worksheet.

A. Divide the amount on line 1 by the amount on line 3. Enter the percentage. A) _____

B. Multiply the amount on line 9 by the percentage on line A. B) _____

   This is your state/local income tax refund that you enter on line 10, Form 1040.

C. Subtract the amount on line B from the amount on line 9. C) _____

   This is your other itemized deduction recovery that you enter on line 22, Form 1040.

[1] Do not enter more than the amount deducted for the prior year.

[2] If taxable income is a negative amount, enter that amount in brackets. Do not enter zero unless your taxable income is exactly zero. Taxable income will have to be adjusted for any net operating loss carryover. For more information, see Publication 536, *Net Operating Losses*.

[3] For example, $700 + ($400) = $300.

Worksheet for Refunds of Itemized Deductions Amounts Deducted Before 1987

If you received refunds, rebates, or reimbursements for any expense you deducted on Schedule A (Form 1040) before 1987, complete this worksheet to figure the amount to include in income on your 1989 Form 1040. If you recovered amounts from more than one year, such as a state income tax refund from 1986 and a casualty loss reimbursement from 1985, complete a separate worksheet for each year. If you also recovered amounts from a year after 1986, you must use both worksheets in this publication. Use information from Schedule A (Form 1040) for the year the expense was deducted.

The amount you may have to include in income is limited to the lesser of the amount deducted for an expense or the amount recovered for that expense. For example, the amount included in income for a recovery of medical expenses cannot be more than the amount shown on line 5, Schedule A (Form 1040) for 1986, or the amount of the medical expense recovery, whichever is less.

A recovery is included in income only to the extent of the deduction amount that reduced your tax in the prior year (year of the deduction). If you were subject to the alternative minimum tax or your tax credits reduced your tax to zero, see *Tax Benefit Rule,* under *Recoveries,* earlier in this publication.

1. State/local income tax refund or credit.[1] 1) _____
2. Total all other Schedule A refunds or reimbursements.[1] 2) _____
3. Add lines 1 and 2. 3) _____
4. Excess itemized deductions for prior year. 4) _____
5. Zero bracket amount for prior year. 5) _____
6. Taxable income for prior year.[2] 6) _____
7. Enter the following adjustment to excess itemized deductions— 7) _____

   If line 6 is:

   Larger than line 5, enter zero.

   Smaller than line 5, subtract line 6 from line 5 and enter the difference.

   A negative amount, add lines 5 and 6 and enter the total.[3]
8. Subtract the amount on line 7 from the amount on line 4. If the result is zero or less, stop here. The amounts on lines 1 and 2 are not taxable. 8) _____

Amount To Be Included In Income For 1989

If line 8 equals or exceeds line 3—

Enter the amount from line 1 on line 10, Form 1040.

Enter the amount from line 2 on line 22, Form 1040.

If line 8 is less than line 3, and either line 1 or line 2 is zero—

If there is an amount on line 1, enter the amount from line 8 as your state/local income tax refund on line 10, Form 1040.

If there is an amount on line 2, enter the amount from line 8 as other income on line 22, Form 1040.

If line 8 is less than line 3, and there are amounts on both lines 1 and 2, complete this worksheet.

A. Divide the amount on line 1 by the amount on line 3. Enter the percentage. A) _____

B. Multiply the amount on line 8 by the percentage on line A. B) _____

This is your state/local income tax refund that you enter on line 10, Form 1040.

C. Subtract the amount on line B from the amount on line 8. C) _____

This is your other itemized deduction recovery that you enter on line 22, Form 1040.

[1] Do not enter more than the amount deducted for the prior year.

[2] If taxable income is a negative amount, enter that amount in brackets. Do not enter zero unless your taxable income is exactly zero. Taxable income will have to be adjusted for any net operating loss carryover. For more information, see Publication 536, *Net Operating Losses.*

[3] Treat the negative amount as positive for this addition (i.e., $3,000 + ($400) = $3,400).

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